

**ADJUSTMENT WITH GROWTH**  
**A Search for an Equitable Solution**

**Edited by**  
**Khadija Haq**  
**and**  
**Carlos Massad**

**NORTH SOUTH ROUNDTABLE**  
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## CONTRIBUTORS

- Dragoslav Avramovic — Former Special Advisor on Economic Co-operation, UNCTA
- Arthur Brown — Associate Administrator, UNDP
- Shahid J. Burki — Director, International Relations Department, The World Bank
- George J. Clark — Executive Vice President, Citibank/N.A.
- Sidney Dell — Executive Director, Center on Transnational Corporations, U.N.
- Richard Fletcher — Deputy Manager for Integration and Inter-national Economic ADB
- Irving S. Friedman — Senior International Advisor, First Boston Corporation
- Mahbub ul Haq — Minister of Planning and Development, Pakistan
- Enrique Iglesias — Executive Secretary, ECLA
- Under Kirdar — Director, Division of External Relations, UNDP
- Carlos G. Langoni — Former Governor, Central Bank of Brazil
- Andre de Lattre — Managing Director, Institute of International Finance
- Azizali F. Mohammmad — Director, Office of External Relations, IMF
- Joseph Ramos — Senior Economist, Economic Development Division, ECLA
- Gustav Ranis — Professor of International Economics, Department of Economics, Yale University
- Frances Stewart — Senior Fellow, Institute of Commonwealth Studies, Oxford University
- George J. Vojta — President, Deak & Company, Inc.
- John Williamson — Senior Fellow, Institute for International Economics
- Roberto Zahler — Executive Director, ECLA/UNDP Project on Monetary and Financial Problems, ECLA
- Khadija Haq — Executive Director, North South Roundtable
- Visiting Fellow, Overseas Development Council, Washington, D.C. Mrs. Haq's previous publications include *Deficit Financing in Pakistan* (1962), *Equality of Opportunity within*

*and among Nations* (editor; 1977), *Dialogue for a New Order* (editor; 1980) *Global Development: Issues and Choices* (editor; 1983) and *Crisis of the '80s* (editor; 1984).

Carlos Massad — Former President of the Central Bank of Chile and former Executive Director of the IMF. Presently Coordinator of ECLA/UNDP financial projects and Professor of Economics at the University of Santiago de Chile. Mr. Massad has published several books and articles on Economics.

## ABBREVIATIONS AND ACRONYMS

BIS — Bank for International Settlements	al Settlements
CEPAL — Economic Commission for Latin America	mission for Latin America
ECLA — Economic Commission for Latin America	ssion for Latin America
EFF — Extended Fund Facility	ility
GAB — General Arrangements to Borrow	nts to Borrow
GNP — gross national product	act
IADB — Inter-American Development Bank	velopment Bank
IBRD — International Bank for Reconstruction and Development (World Bank)	nk for Reconstruction and Development
IDA — International Development Association	opment Association
IFAD — International Fund for Agricultural Development	d for Agricultural Development
IIF — Institute of International Finance	onal Finance
IMF — International Monetary Fund	ary Fund
LDC — less developed country	try
LIBOR — London Interbank Offered Rate	lk Offered Rate
ODA — Overseas development assistance	ent assistance
OECD — Organization for Economic Cooperation and Development	Economic Cooperation and Development
SDR — special drawing right	it
UNCTAD — United Nations Conference on Trade and Development	as Conference on Trade and Development
UNDP — United Nations Development Programme	velopment Programme

## PREFACE

Late in the summer of 1983, the North South Roundtable on Money and Finance met for the first time in Istanbul, Turkey. The meeting brought together over two scores of experts in the field of international finance to discuss the critical problem of Third World debt and to seek solutions to the present crisis of international finance. Out of that meeting came the volume *Crisis of the '80s*, a collection of papers by both international and national policymakers, administrators and economists, examining international financial and monetary issues and the impact of the crisis on economic and human development in the Third World.

The present volume is a product of the second session of the Roundtable on Money and Finance, which was held in Santiago, Chile, in February 1984. In Santiago, the Roundtable participants focused their presentations and discussions on the subject of the adjustment process: the efficacy and equity of the adjustment packages being imposed on debtor countries by the IMF, the appropriate role of the international agencies in overseeing the adjustment process, the possibilities for sharing the costs of adjustment between debtors and creditors, and the economic, social, and political impact of typical IMF adjustment measures in developing countries. The papers collected here are representative of the proceedings at Santiago. In these papers the authors give their personal views which should not be attributed to the organizations with which they are affiliated.

Part I of this book presents four papers reviewing the policy issues pertaining to the management of the international debt situation. Mahbub ul Haq, in Chapter 1, proposes some international initiatives in order to provide immediate relief to the debt-ridden developing countries and to ensure long-term viability and stability of the global economic system. His package contains a new SDR allocation, a concessional fund to supplement the inadequate level of the seventh replenishment of IDA, and a debt conference between the debtor and creditor countries and institutions. In Chapter 2, Enrique Iglesias reviews the circumstances leading to the huge debt burden of the Latin American countries, pointing out both the inadequacy of domestic policymaking as well as the unfriendly international atmosphere of huge interest rates and high deficits in industrialized countries and falling terms of trade of LDCs. He

questions the equity and the suitability of the adjustment measures that are being undertaken by the Latin American countries as the costs are being borne exclusively by the debtor countries and the mechanism involves contraction of demand with political and social implications. Irving Friedman, in Chapter 3, describes the recent activities of international agencies, banks and governments as crisis management, sufficient to ease the present circumstances, but not suited to the needs of long-term economic management. And Andre de Lattre, in Chapter 4, portrays the instability of current international conditions in finance and trade, but points to encouraging developments in the policies of the developing countries in particular. He advises borrowers to keep up the adjustment process and the lenders to "keep on lending."

In Part II the theme is "The Adjustment Process," where Carlos Massad and Roberto Zahler present a scholarly analysis of internal and external economic disequilibria and of the mechanisms of adjustment. They argue that the current approach to adjustment, with its recessionary bias, has succeeded mostly in buying time for the international system and may not even be able to do that much longer. In the short-term, the real burden of the debt service requirements must somehow be reduced; and some parties to the debt will have to absorb the loss. And for the future, adjustment must be oriented more to development.

The chapters of Part III fill out the analytical framework with examinations of the adjustment experiences, good and bad, of various countries in the regions of the Southern Cone of Latin America, South and East Asia, and sub-Saharan Africa. Richard Fletcher has provided an overview of the issues and discussions presented here (Chapter 6).

The subject of Part IV is IMF conditionality. The papers include an analysis of this topic by an insider at the IMF; a discussion of the importance of developing alternative forms of conditionality; and a look at the impact of conditionality on human conditions. An overview of some of these issues is given in Chapter 10 by Shahid J. Burki.

The final section, Part V, presents a selection of papers featuring possible concrete responses to the debt situation. The reader is particularly referred to Richard Feinberg's excellent overview (Chapter 15) for a summary of the contents of these chapters.

Appended to this volume are the *Santiago Statement*, a list of participants at the Santiago Roundtable, and a summary of the purposes and activities of the North South Roundtable and its various task forces.

The analyses and deliberations of the Roundtable on Money and Finance will continue when the Roundtable meets for the third time this autumn in Vienna. The Vienna Session will focus on mechanisms of debt restructuring, the connection between debt and trade issues, and the formulation of institutional responses in these areas.

The fourth and the final session of the Roundtable is scheduled to be held in the spring of 1985 when we hope to be able to come out with a concrete blueprint for convening an international conference on financial and monetary issues.

The North South Roundtable is grateful to the co-sponsoring organizations, Economic Commission for Latin America (ECLA), UNDP Development Study Programme and the United Nations University for the Santiago Roundtable and for this volume. The North South Roundtable is particularly grateful to the Economic Commission for Latin America, especially its Executive Secretary, Enrique Iglesias for making Santiago Roundtable happen; Carlos Massad and other professional staff of ECLA for their substantive contributions; and ECLA's conference coordinating staff for their superb organizational skill. The financial support provided by the World Bank is also gratefully acknowledged. Most of all, the Roundtable is deeply indebted to the authors for the excellent papers they produced.

The manuscript of this volume was completed in June 1984 in Washington, D.C.. The printing phase was done in Islamabad where the Roundtable Secretariat moved later on. The Chairman of the Agricultural Development Bank of Pakistan deserves a special mention for providing the Roundtable with all the help that was needed to complete this volume.

Khadija Haq  
Islamabad, Pakistan  
August 26, 1984

# **PART I**

## **POLICY ISSUES**

“The question is whether we are really moving towards basic solutions or are only buying time, especially in view of the fact that the international recovery has not yet shown any signs of spreading its positive effects to the periphery.”

— Enrique V. Iglesias



## CHAPTER 1

### *A Pragmatic Approach to the International Monetary Muddle*

**Mahbub ul Haq**

As we meet in Santiago, we should remind ourselves that there is an excited debate going on in many of the international fora.

There is a school of thought that believes that the immediate financial crisis is over and we can all return to business as usual without further institutional and policy changes. The arguments advanced are formidable ones: it is quietly suggested that the major debt problems have been surmounted without any financial collapse; that the world is coming out of its deep recession; that inflation is under control in the developed countries; that OPEC has been seriously weakened and, as such, the possibility of major disruptions of the world economy from that quarter are greatly muted; that protectionism, while on the rise, has not severely damaged international trade; and that Bretton Woods institutions may have dealt with the adjustment problem in a somewhat harsh way but at least they have managed to avoid any major international financial and economic disruptions.

There is another school of thought that argues as fervently that the immediate crisis is not over, but only postponed, and that we now have the opportunity to put in place those institutions and policy changes which would prevent the recurrence of such a financial crisis in a much worse form in the near future. This school of thought would argue with equal force that the cost of adjustment for the developing countries has been massive, in terms of lost output, depressed employment and rising poverty. In fact, unemployment rates of 25 to 30 per cent, cuts in real wages of as much as one-third and declining per capita incomes in Africa and many developing countries are not very reassuring indices of a successful adjustment process. This school of thought will also point out that the debt problem has not been solved but postponed, with present obligations delayed at the cost of higher payments in future; it will argue that debtors, especially in Latin America, are experiencing now a net transfer of resources to the rest of the world; and it will also

argue that the long-term problems still await solutions. The world still has not found either a viable or a safe mechanism for creating and distributing international liquidity.

I believe that the Santiago Roundtable is not an occasion to rehearse these heated arguments but to design some practical solutions to provide both immediate relief and long-term stability. After all, world economic recovery is still very weak. The developing countries are paying a heavy price for their adjustment in terms of lost output and human suffering, and many countries, particularly in Africa, are experiencing a prolonged fall in their already miserable income levels. As such, the need of the hour is to settle on some practical steps, some partial solutions, because the world problems will not wait while we construct our brave new visions. Let us by all means keep searching for those grand visions, since the world is ruled by little else in the last analysis, but let us also not hesitate to take the first few positive steps, however inadequate they may appear at first sight. It is in this spirit that I would like to suggest four specific proposals for the consideration of this Roundtable.

### **Another SDR Allocation**

I believe that the time has come to consider another SDR allocation by the IMF. The last SDR issues were in 1972 and 1978. The rationale of SDRs is basically threefold. First, they provide an alternative and controlled means of reserve creation, without having to depend on the United States' deficits to perform this role in an *ad hoc* fashion. Secondly, the SDRs enable all countries to build up reserves overtime without the need to arrange payments imbalances. Thirdly, and most importantly, they give an opportunity to the less-developed indebted nations to build up their reserves without the need to run excessive current account surpluses and to transfer real resources to the rich nations.

The case for an SDR issue today is basically that inflationary trends are weakened by now and, in fact, deflationary policies in many developed countries require an international offset. Secondly, international liquidity has not grown recently in line with international trade. In fact, reserve-import ratio has been falling. It has fallen from 40 per cent in 1972 to 28 per cent in 1978, and to 23 per cent in 1983, so that in many capital-importing developing countries the reserve-import ratio is dangerously low at present.

Normally, the increase in reserves should keep pace with the increase in world trade. Thirdly, capital-importing developing countries require some additional reserves without having to pay an unacceptable economic and social domestic cost for acquiring them. This consideration becomes even more important at a time when international liquidity is shrinking from the private banking system. Fourthly, gradual creation of SDRs is presently the only means for diversifying the control over the creation of international liquidity. SDRs, after all, were supposed to provide an international alternative to the exclusive national control over reserve creation but they have shrunk from 8 per cent of non-gold reserves in 1972 to 4 per cent in 1978 though they were expected to acquire an increasing significance over time.

The case for an additional SDR issue is, therefore, a formidable one. Specifically, I would suggest that we consider an issue of 40 billion SDRs for a basic period of five years, from 1983 to 1988, at the rate of 8 billion SDRs a year, with front-end loading in the first year when two years' allocation can be provided. This specific proposal is based on the following premises: International trade is likely to increase by 4 per cent a year, which will increase demand for reserves by about 16 billion SDRs a year, of which at least one half should be provided by the IMF.

According to the present rules, these SDRs will have to be distributed according to the member countries' quotas in the Fund. There is no way we can change this practice without changing the Articles of the IMF which is almost an impossible process. However, we must recognise that these historical quotas do not reflect current needs. Many rich nations do not need more free foreign exchange reserves while the needs of the developing countries are far in excess of their quotas in the IMF. As such, I have another improvisation to suggest within the SDR framework. It may be possible to persuade some surplus countries to place their SDRs in a trust fund for the next five years, to be administered by the IMF, and this trust fund can be used to subsidize interest payments for the poor countries, as well as to restructure debt profiles for some of the most heavily indebted countries. I believe that such a step will offset liquidity squeeze, will provide some reserves without painful domestic adjustments, will provide some flexibility to look after heavily indebted as well as the poorest developing countries, and it will also increase the

use of SDRs over time to about 13 per cent of the total reserves by 1988. I do not wish to press these concrete magnitudes. They are only illustrative. But the basic proposal for another SDR issue deserves serious consideration by the international community.

### **IDA Supplementary Fund**

We should also consider a supplementary concessional fund to supplement the very inadequate levels of the 7th IDA replenishment of 9 billion dollars. I do not think that there is a full realization yet as to what has happened to IDA, the largest concessional window in the world for the poorest nations. The real level of next IDA replenishment is about half of the last one while potential claimants have doubled in number with the inclusion of China. We have a doubling of demand but a halving of supply. That is why it is imperative that those countries which wanted to contribute a higher level of 12 to 16 billion dollars to IDA-VII but were prevented from doing so by the negative matching principle of the United States, should now be encouraged to establish a supplementary concessional fund. Such a supplementary concessional fund will also give the international community the necessary flexibility to design new terms, conditionality, control structure and policy framework than in the original IDA, if the contributors so desire. The target should be to raise at least 5 billion dollars over the next three years — a difficult, but not an impossible, target if only the U.S. is gracious enough to accommodate changing world conditions rather than to keep trying to roll back the waves of change.

### **Debt Conference**

Instead of temporary improvisations to the debt problem, which are admittedly buying some much-needed time, we must now focus on a longer-term solution. This cannot evolve without consultation with the borrowers. There is, therefore, a need for periodic conferences between the indebted developing countries and the private banking system. It is in that spirit that I would suggest that we organize a debt conference between the most heavily indebted countries, about 8 to 10 countries, and the principal private banks, with the inclusion of IMF, World Bank and the Institute of International

Finance. Such a conference should discuss the costs involved in a long-term restructuring of debts and the mechanisms for sharing these costs.

We must accept that the debt problem has arisen not out of the irresponsibility of the developing countries. If they had been irresponsible, we would have seen one of the worst financial crises in our history, because there would have been widespread debt defaults. The developing countries wish to handle this issue with utmost responsibility. We must enable them to do so and, as such, we must accept that a part of the cost has to be borne by others who contributed to this debt problem. The private banking system is just as guilty in this process as the developing countries as there can never be overborrowing of funds without overlending of funds. And the international community that watched this phenomenon with tremendous satisfaction during the 1970s, since petrodollars were getting successfully recycled, has to take just as much responsibility. It is within that framework that a quiet and informal dialogue should take place, with no posturing around the table. That will afford an opportunity to the Fund to review its conditionality, to the private banks to see what part of the cost of restructuring debts they can assume, to the developing countries to see how much of the real adjustment they must go through.

### **Institutional Solutions**

The three proposals that I have made will provide some breathing space, but no permanent solution. The long-term policy and institutional issues still await our attention. These issues concern the need to devise mechanisms to ensure adequate creation and distribution of world liquidity; more responsive mechanisms to meet the resource transfer needs of the poorest countries; a basic restructuring of debt of LDCs as well as restructuring of debt portfolios of the commercial banks; a correction of the present lack of symmetry in the responsibility for balance-of-payments adjustment between deficit and surplus countries; the nagging issue of exchange rate and interest rate instability; some international control over the presently largely unregulated capital markets; the need for an institution to perform both the role of the lender of last resort and some of the functions of international co-ordination of national monetary policies; and careful

management of world economic growth through counter-cyclical policies and needed resource transfers. These are fundamental issues: they require a good deal of debate in our current deliberations. It may not be possible to reach a final consensus on all of these issues or on any one of them. But our role is to seek a process of constructive dialogue even when final solutions evade us.

### **Concluding Remarks**

Let me conclude with just a few observations: let me suggest that while the problems are enormous, this is no time to get dispirited; this, in fact, is a time for designing the next practical steps.

About eighteen months ago (in October 1982), at Oiso, we issued a call for a fundamental re-examination of the existing international monetary system and for a Second Bretton Woods. That call was heard. We have seen it repeated in various fora, including the Non-Aligned summit in 1983, the Commonwealth Conference in 1983, the G-7 summit and in many other fora and seminars.

Six months ago (in August 1983), at Istanbul, we took the next step and provided a sober diagnosis of what had gone wrong with the international financial system. This analysis was presented to the annual meeting of the World Bank and IMF in September 1983 and I believe it considerably influenced international deliberations.

Now, at Santiago, it is our duty to suggest a few practical steps to restore greater health and vigour to the international economic and financial system, and it is in this spirit that I have offered a few practical proposals, I hope many more will emerge, but this is the framework within which we should proceed.

I strongly believe that what the world needs today is not elegant analyses or eloquent presentations, but a few workable solutions, however modest, however short they may fall of our ultimate ideals. We must start here a process, a process of responsible change, whose logic proves irreversible and whose momentum is carried over to finding more fundamental and basic changes in the international order. And let me also suggest that, while many of us in the developing countries are bruised and battered today and while the bitterness of our immediate experience may sometimes overwhelm the calmness of our analysis, let us at least try to win respect in international

fora by the force of our arguments and not by the force of our language. And let the international community note that a responsible group met in a responsible forum in Santiago and produced some responsible proposals which in their substance and in their reach commend themselves to the urgent attention of the world community.

## CHAPTER 2

### *Latin America in Crisis and Adjustment: Some Observations*

**Enrique Iglesias**

We are here to deal with the problem of the crisis: a crisis whose diagnoses have been explored fully in recent times, to such an extent that a wealth of common viewpoints and conclusions have been reached by the international community. Perhaps the foremost of these shared observations is the unexpected rapidity of the crisis. The crisis shook the world, and especially the Latin American region, in a way which was nearly impossible to predict. Although difficulties and problems in the functioning of the international financial system were already beginning to appear in the 1970s, the magnitude and extent of the recession and its repercussions could not have been anticipated by the international community. What is even more serious, the world's capacity to look ahead has been shrinking dangerously in recent years, so that we are today in a state of uncertainty such as we have not known since perhaps the Great Depression.

Another common conclusion is that the phenomena involved in the crisis are highly complex. Not only are we confronted with a reversal of the cycle, as in other times, but we are facing deep structural changes, making the solution of the problems much more complex and difficult to approach, at least in comparison to other critical moments experienced since the Second World War.

Together with the lack of predictability and the complexity, there is the confusion to which certain phenomena are subjecting us. Already in the 1970s "stagflation," as it came to be called, was upsetting certain theoretical foundations. The current persistence of high interest rates, which everyone recognizes as the most unusual in many decades, is truly difficult to approach and yet is exceptionally important to all the other phenomena in the economic spectrum. Our confusion occurs not only at the theoretical level, but also at the political level and as regards what all this will mean for the handling of the international economy in the coming years.

There has been much talk of a world crisis. But the experience of recent years shows that although the difficulties originally had implications for the entire international spectrum, there is today a great lack of symmetry in the way in which the costs of the crisis are being distributed and in the way in which the crisis is currently affecting the different regions of the world. The term therefore needs to be qualified. It is certainly true that there is a world crisis, but it is also true that there are regions or countries which have suffered this crisis to a greater extent than others. Unfortunately, Latin America is the region of the Third World, or at least one of the regions, which for many reasons has suffered most severely from the repercussions of its own problems and the effects of the international cycle.

It should be stressed that, although the problems of the world financial system have increased, although they have been complex and difficult, the international community's capacity for administration and support has also fortunately broadened. If the crisis we are experiencing today had arisen in the same terms thirty years ago, the capacity for support would surely have been much smaller. This leaves some feeling of satisfaction in the cooperative efforts which the world has been making in the last thirty years and which have not been in vain. Despite the seriousness of the current situation, we have managed so far to avoid an international breakdown which could have taken our experience to unmanageable and tragic limits. In this respect, we cannot fail to recognize that there has been an administrative capacity which has mobilized international cooperation, and this is an asset which we must not overlook.

For Latin America, the problem also took the form of a high degree of unpredictability, great complexity, and some confusion. In the 1970s we Latin Americans never foresaw the extent to which the external crisis could affect our economies, nor the intensity of the recession of the 1980s. Their present impact was beyond the predictive capacity of all sectors. The crisis has been generalized in Latin America, encompassing countries which have followed orthodox economic policies and those which have followed unorthodox policies; it has encompassed petroleum-producing and non-petroleum-producing countries; it has encompassed large countries and small countries. Our traditional problems of economic underdevelopment — the structural problems we so often discuss — have been

compounded in recent years by the problems of the international economic situation which have affected the region severely and which raise again the issue of the extreme dependency of our growth on external economic variables. Because of this dependency, in the 1980s we came to the end of a growth cycle which for two or three decades had attained average rates of 5 per cent, and we entered a truly tragic three-year period: that of 1981-83, which saw a spectacular fall in GNP in the majority of the countries of the region, at rates which in some cases amounted to a 15 per cent drop in one year, with an equally spectacular decline in investment, and acceleration of inflation. Together with the economic impacts, the social effects have been extremely serious, in some cases reaching the limits of social and political tolerance.

The history of this situation contains a series of stages: first, in the 1970s, there was a dynamic expansion of the Latin American economy, with great diversification and opening-up towards the exterior at a rate higher than that of the growth of the product. This explains why the problem of external indebtedness did not unduly alarm the region until the end of the 1970s and the beginning of the 1980s, when the change of course of the international economy, the drop in the terms of trade and the enormous surge in interest rates created an absolutely unmanageable situation, in which the region had to assume debts of unprecedented proportions. It has now acquired an accumulated debt which is close to US \$310 billion.

The external cycle, then, has been of fundamental importance in the worsening of external conditions, but it was the financial policy of 1982-83 (which we in ECLA have termed the financial depression) that posed the problem in much more difficult terms. In 1982-83, Latin America experienced a violent drop in the inflow of private capital, which, after having at some point amounted to US \$29 or 30 billion per year, dropped to less than \$5 billion, so that the region became a net exporter of capital, at a rate which in 1982 exceeded US \$30 billion. Thus, the cycle began with domestic economic problems and strategies, worsened because of the international economic situation, through the fall in the terms of trade and the rise in interest rates, and gathered speed with the financial depression of 1982-83.

The region is responding to these problems with a large-scale adjustment, with a sharp contraction in domestic spending accompanied by a drop in production and a severe compression of our

import capacity, in order to generate the necessary surpluses to service the bulk of the interest on the debt.

The fact is that at no time did the region fail to act with a high degree of responsibility. Latin America's response, compelled by external circumstances, was that of tightening its belt, adopting policies of extraordinary austerity, and meeting its external commitments. At no time did Latin America consider irresponsible actions such as repudiation of the debt: actions which could have destabilized the international economy, or which could have blemished Latin America's traditionally clean record of fulfillment of obligations.

However, the entire situation today is surrounded by doubts which arise from our observation both of the international scene and of what is occurring within Latin America. There are three doubts in the international arena and three doubts in the regional arena, which I believe are ultimately the points around which our questions and our incapacity to respond are focused.

In the international sphere, one important question for all of us is the strength of the current recovery in the economic centers where it is taking place and its capacity for reactivating the periphery. The Latin American governments, the International Monetary Fund, the monetary authorities of major governments and the private banking system itself, have staked their hopes on an adjustment process whose central hypothesis was that a recovery in the major economies was going to change the international setting; that the adjustment was inevitable and painful, but that it would only last for a certain amount of time; and that changes in interest rates and the terms of trade would create the conditions for a recovery and a reversal of the cycle, thus overcoming the difficulties of the current adjustment. However, when we view the opinion of the international authorities on this topic, we are all left with a deep concern — both those of us (especially in the international financing bodies) who are confident that a reversal of the cycle is possible and imminent, and those who are becoming increasingly pessimistic and doubtful with regard to the capacity of the system as a whole to survive the present conditions.

Certainly, when we look at the results of 1982, we cannot be too optimistic. For Latin America, at least, the terms of trade did not respond as we had hoped, and no one expects them to recover brilliantly in the next few months. Furthermore, and what is much

worse, interest rates — the key variable today for many of the Latin American problems as well as for the international economy — not only did not fall, but are even expected to stay up for some time. This must give us strong doubts about the recovery.

I do not wish at this point to voice my additional doubts, such as the long-term viability of an expansion of the international economy based on these high interest rates, or the persistence of high deficits in the major centers, or the monetary breakdown in the central economies, which sometimes curiously reminds us of some experiences in the Southern Cone in recent years. In fact, there are similarities between the monetary and balance-of-payments policies which prevailed in the past in the Southern Cone countries, and those pursued today to some extent in the major centers.

The second question in the international sphere is whether this adjustment process in the Latin American periphery, which is essentially burdening the debtor countries, is viable in the long-term. The experience of the past was quite different, since the distribution of the costs of adjustment between debtors and creditors was nothing like that of today. In recent years, the adjustment of the 1980s with regard to Latin America and the debtor countries of the Third World is an adjustment which is basically affecting the debtor countries. Interest rates continue to be very high, the costs of financial mediation have increased, in some cases excessively, and the extension of guarantees — not only those agreed with the IMF in connection with its intervention in the adjustment policies, but also the public guarantees to private debt — certainly illustrate beyond any doubt the great importance of this topic. We are in the presence of a large-scale, long-term adjustment, where in actual fact the costs of the adjustment are almost exclusively affecting the debtor countries. Our question is whether a crisis of this magnitude, approached on these terms, is viable.

The third question, also in the international sphere, is the viability of the application of traditional mechanisms, involving only the contraction of spending, to a situation encompassing such a great number of countries and with such an intensity of adjustment as that being experienced today by many countries of Latin America. This raises theoretical questions and also political questions, and leads us to an analysis of the entire topic of current conditionality. I believe that we in Latin America have gone beyond the period

when we believed we could solve these problems without paying anything. I believe everyone recognizes that to emerge from these crises, one must pay something, and that in view of the shrinkage of the current volume of income, there can be no painless adjustment. The question is whether orthodox mechanisms involving the contraction of spending and the general contraction of the economic system are really sufficient, under current conditions, to get us out of the woods. Once more, these questions are being asked with great honesty and the legitimate desire to ensure that what we are doing will really work. Our question arises from our premonition, when looking at the current realities, that if the enormous efforts being carried out by governments do not work, we could have some very difficult times ahead of us. The question is whether we are really moving towards basic solutions or are only buying time, especially in view of the fact that the international recovery has not yet shown any signs of spreading its positive effects to the periphery.

We Latin Americans wish to avoid some of the temptations of the past in this region — the temptations of thinking that all of our problems come from outside, or that solutions should also come from outside. Fortunately, I believe we have gone beyond this simplistic stage of externalizing the blame without looking at many of our problems and our own responsibilities from the inside. For this reason, today in Latin America we are asking ourselves three questions, which will surely arise in the analyses of our Latin American colleagues on more than one occasion, but which I would like to repeat here for this audience.

One question which we have all asked ourselves is how we got into this crisis. And here I believe that we have been reaching general agreement, not only in intellectual but also in political circles, that there has been a mixture of factors. On the one hand there were mistaken strategies of domestic development, accompanied in the 1970s by extreme permissiveness on the part of the international financial system, which assumed the role of recycler of funds, with everyone's compliance. I still remember the time when we were very grateful to the financial system for assuming the role of recycler of petro-dollars. But we must acknowledge that among the origins of the crisis were strategies which gave undue preference to external indebtedness as a basic motor of growth, as an element which made it possible to postpone petroleum price adjustments, as an instrument for expanding domestic spending, and as an instru-

ment for stabilizing or keeping down the exchange rate. But although we must agree that at the outset there was internal fault, there is no doubt whatsoever that the worsening and deepening of the crisis in the region has taken place with the collaboration of the international cycle. The problems of Latin America up to 1980 were relatively manageable; in that year it was the interest rates and the terms of trade which made the problem totally unmanageable and precipitated the crisis. And the behavior of the international financial system in 1982 and 1983 certainly made the problem more serious and put it out of control. This sequence of elements has become a generally accepted diagnosis in Latin America.

A second inward-directed question raised by our observation of the political realities which we are experiencing, is whether the current mechanisms, to the extent that the elements of the external cycle stay the same, really reconcile the economic viability of the adjustments with their political viability. We certainly cannot overlook the inevitable cost of the economic adjustments, but neither can we ignore that we are living in political societies; and once the adjustments become as extensive and long-lasting as they are today, there is some question whether there will be enough political support and capacity on the part of governments to endure the social climate and keep up the application of these adjustment policies. So far the governments have all proceeded with the strong belief that the adjustment is possible, but often the magnitude of the adjustment is such that social forces may go beyond the governments' capacity and will. If anything that conveys the spirit of Latin America today, it is the desire to help the international financial system develop a stability which will sustain the system and sustain us through our future development. Perhaps, then, the basic question — and this is what emerged from the recent meeting in Quito — is how we can improve the atmosphere of the international adjustment, in the area of resources and in the area of conditionality, in order to avoid more severe effects, and, above all, how we can create conditions which will enable the region to make the adjustments which it must inevitably make, by extending their costs over time and attempting to avoid unmanageable conditions. The report which emerged from the Quito Conference convened by President Hurtado is a statement of extraordinary responsibility. The governments and heads of state discussed the crisis together for the first time with great care,

attempting not to create alarmist feelings, repeating their will to meet their commitments, but also stressing the implications of a situation which, if it continues on its present path, will be difficult to control domestically and could slip out of the governments' grasp.

The third and last question for our region is one which I believe is positive for us. This crisis is leading us to rethink the bases upon which we have designed our economic development strategies in recent years. I believe that, like all crises, this one is violently upsetting theoretical conceptions and also upsetting many of our perceptions of reality, at both the intellectual and political levels, and that it is going to compel us to think of Latin America in the future in different terms. The crisis is going to compel us to think about why it has been borne or managed better in the countries of Southeast Asia than it has in Latin America. What are the elements that helped those countries gain greater flexibility to weather the international economic situation and to manage their development processes without the kind of violent traumas we are experiencing?

Certainly, when we think in terms of the future, we will have to examine what opportunities the international climate offers us, what is going to happen as regards transparency in trade, and what is going to happen with financial flows. All these factors will be of extraordinary importance to us in making our own provisions. What we must recognize today as Latin Americans is that we have to make an intensive examination of our past experiences and we have to reformulate development strategies, but not in terms of drastic or apocalyptic solutions — because the world is not ready for this, and Latin America, in the middle of this crisis, should not think in such terms either. But we can reflect on all our experiences and realize that this region certainly has opportunities which must not be neglected and which must be reinterpreted and put forward again as part of the future strategy.

In sum, we must first see whether it is possible to improve current international cooperation mechanisms, in such a way that the schemes and the broad range of instruments available to the world today can be mobilized to help facilitate adjustment and to permit us to handle these processes more easily in the coming years. This is the first challenge — the challenge of international cooperation.

Another challenge is the challenge to our capacity to internalize the experiences of the last decade, to rethink the type of adjustment

needed in the coming years in order to sustain our economic development, and to stimulate ourselves in the area of ideas. I believe that there has been a sort of intellectual abandonment in the face of these problems in recent years. The type of discussion we are having here should help to stimulate us and help us think a little more clearly of the years ahead and of the challenges presented to us by this crisis.

## CHAPTER 3

### *Crisis Management, The Business Cycle and International Lending*

Irving S. Friedman

The world has been experiencing the most severe cyclical downturn in depth and duration since the 1930s. Evidence of the downturn has been seen vividly worldwide in output, income, employment, growth, private productive investments and international trade. From the 1940s to the 1970s, the world business cycles had been rather shallow and the downswings much shorter than the upswings. Indeed, many believed that downturns comparable to the Great Depression of the 1930s would not occur again. The depression of the 1980s was not accidental or automatic. It was the means by which the industrialized countries chose to fight the persistent inflation which by the 1970s was threatening to get out of hand. Governments tried to limit budgetary expenditures and reduce the relative size of their fiscal deficits, but at best they were only partially successful. Restrictive monetary policy became the principal weapon in the anti-inflationary arsenal, and the private sector bore the brunt of the anti-inflationary policies. The shallow and short lived business downturns of the 1970s gave way to the prolonged depression of the 1980s.

Before these most recent years, attention in the world economy had not centered on cyclical phenomena, although they never escaped attention. The economic and financial issues of these earlier years were essentially non-cyclical. They included first and foremost the reconstruction of the war-torn countries; the re-establishment of the convertibility of the Western European and Japanese currencies; the elimination of dollar discrimination in international trade; the reopening of international capital markets to bond issues; the birth and expansion of the Euro-currency market; fears for the adequacy of international liquidity and the desire to have a mechanism to create international liquidity separate from the balance-of payments behavior of the United States; the evolution of the Common Market; the need for a World Central Bank; the persistence of

global inflation; the need of the less industrialized and poorer countries constituting the majority of the human race to accelerate their modernization; the desire to avoid a global debt problem as had existed between World War I and World War II; the adaptation of international trade rules to rapidly changing production and trade conditions in the less industrialized countries; the role of international commodity agreements; ways and means of promoting transfers of capital and technology to the poorer countries; the population explosion; the widespread expectations of world food shortages by the 1970s; the need for more energy; the impact of the new technologies in production, transportation and communications; global interdependence resulting from structural change, etc. This list may help remind us how much we focused on non-cyclical matters for about thirty years. Business conditions and business cycles were an ever-present subject, but they were not a cause of deep fears and pessimism as they had been in the 1930s and would be again in the 1980s.

Because of the then recent background of the Great Depression, the International Monetary Fund and the World Bank were designed in the mid-1940s to deal with cyclical downturns, though the IMF was more clearly inspired by these purposes than the Bank. In practice, these and other similar institutions, like the regional multi-lateral development banks, dealt mostly with non-cyclical problems. Interest in monetary theory, experience and policy flourished, while scholars of "long" cycles or secular trends like Kondratieff Forester and "Clubs of Rome," also flourished. Business cycles occurred, but they were not devastating.

The world economy did reasonably well in the 1950s and 1960s in terms of the real growth of nations and the expansion of international trade. In the 1970s, the world economy faltered. The 1970s became a decade of surprises and responses to those surprises. Oil price increases were followed by special national and international oil facilities and credits. Programs to find new sources of energy, expand existing sources and encourage more efficient usage and conservation became fashionable. Many developing countries tried to sustain development programs despite the adverse balance-of-payments effects of the oil price increases, accelerating world inflation and certain weak commodity prices. The inadequacy of the available concessional sources of finance led to huge borrowings

from the commercial banks, another surprise. Governments failed to improve the performance of the public sector — including the budget, which became a major source of inflation — even when political leaders seemed determined to do so: another surprise. Monetary policy was not an adequate substitute for needed fiscal policies — another surprise. Floating exchange rates did not result in manageable balance-of-payments positions or even realistic exchange rates, as governments repeatedly found it impractical to leave the market alone to do the job of adjustment — another surprise for many.

The world economy reeled under the impact of these surprises, which disrupted efforts to cope with existing conditions, including the cyclical downturn in the mid-1970s. However, adjustments were made, greatly facilitated by the availability of funds from international credit and capital markets. Some countries like Zaire, Peru, Turkey and Jamaica had to reschedule their external debts. A number of the industrialized countries made large, temporary use of international credit from banks and institutional investors. The world economy lurched and slipped, but it was not overwhelmed by the surprising adversities. Growth of the world economy became much less rapid. Contractions were experienced but were short-lived. Growth was expected to continue, and world trade was expected to continue its expansionary trend, though more slowly than in past years.

Adjustments in the 1970s to the adverse surprises were often painful, but usually manageable. An important factor in this manageability was that the surprises often meant exceptional prosperity for some, with severe costs for others. Those who benefited could help ameliorate, directly or indirectly, the pains of others. The depression of the 1980s created a very different world environment: all countries were hurt; there were no beneficiaries. A severe and prolonged downturn in the business cycle created unmanageable conditions and gloomy prospects for most. The stronger countries could help the weaker, but these strong countries were also suffering from adversities of the business cycle, while former strong oil-exporting countries like Mexico, Venezuela and Nigeria were also in serious difficulties and were unable to help others as they had done earlier.

The depression of the 1980s made cyclical conditions dominant. World conditions dramatically changed, aside from the depression itself. Inflation was at least temporarily dampened. The role of

government in the economy and society was re-opened for examination. The need for thoroughgoing fiscal changes became evident. National priorities were seriously challenged and revised. The need for innovation and novelty in many areas was obvious. Weaknesses in areas like education, environment, health, law and order could not be set aside or neglected. What had been a weakness in a growth economy became a serious illness in a non-growth or shrinking economy.

While the new depression has brought its own pressures for change, the world continues to undergo the rapid technological revolution which creates its own strong pressures for change. These technological changes make the commercial and industrial transformations of the fifteenth through nineteenth centuries seem slow in comparison. The current changes are so sweeping, strange, and profound as to defy description. We do not feel confident about what to expect in the coming decades. Uncertainty has been added to pessimism. For the adventurous, the times call for action and risk-taking; for the manager, they call for caution and avoidance of risk.

The depression of the early 1980s created a sense of worldwide crisis and impending financial disaster which still persists (February 1984) in many quarters. Expectations were based on the prototype of the Great Depression of the 1930s — the severe, prolonged, global depression that had hit industrialized and non-industrialized countries and caused widespread financial crisis, including international defaults by borrowers throughout the world. National banking systems including that of the United States had been seriously damaged in the 1930s, and large individual banks had been submersed. Rescue operations by national financial authorities and major changes in banking regulations and practices had been commonplace, and the international monetary system, with its ties to gold, had been disrupted. Economic nationalism and autarchy had guided national policies as exchange rates had become weapons of fierce international competition. War debts and reparations payments from World War I were among the first victims of that first global economic disaster. Nationally and internationally, non-servicing of debt and declarations of bankruptcy were frequent. There was widespread fear that what happened in the 1930s could recur in the 1980s. The external debt and debt servicing figures of the early 1980s were astronomical by historical standards, reflecting years of

persistent inflation as well as real changes. Moreover, the borrowers of the early 1980s were the poorer, low-income countries of the world, whose weaknesses had been the subject of public discussion for years. Prophets of disaster in the 1980s have sounded realistic and persuasive. Many shared this pessimism, and more guarded views were regarded as pusillanimous or unrealistically optimistic.

Many countries experienced financial crises during the depression of the 1980s. Difficulties in servicing external debt were usually accompanied by domestic economic difficulties. Developing countries had to cut back on needed economic and social investments. Developed countries became increasingly protectionist as economic nationalism became respectable. The U.S. dollar was strong, as inward flows of capital more than financed the United States' current account deficits. The strong dollar encouraged imports into the United States, at a time when the U.S. economy was experiencing severe recession — a sure recipe for strengthening protectionism.

Thus, in a sense, the pessimists in the early 1980s had been correct in anticipating difficulties. The difficulties, however, included countries previously considered strong (and safe for lenders) and did not lead to the collapse of national banking systems or international banking. The business cycle of 1981-83, though severe and prolonged, did not follow the pattern of the 1930s. The banks in the industrialized countries weathered the storm with few exceptions, though with considerable pain. The developed countries had ready access to the international credit and capital markets. Despite the widespread prognostications of financial collapse and the temporary borrowing difficulties of some industrialized countries, those countries preserved their international creditworthiness in currency and capital markets. Even repeated difficulties of some large public or private borrowers did not create runs on banks in the industrialized countries. Capital flight seeking a safe haven in the United States or profiting from high interest rates did not reflect worry about national banking systems. Capital markets in these years were, at times, disrupted by the volatility of interest rates and the strange shapes of yield curves. These conditions were troublesome and worrisome, but they were not the ingredients of a financial crisis as historically defined by the experiences of the 1930s.

Nevertheless, the Achilles heel in the international financial system was and still is identified as the very large indebtedness of

developing countries to commercial banks. All other debt figures were simply ignored. The oft-predicted collapse was expected to come from the failure of the major developing country borrowers to service their debts. To a financial world that had long accepted that a commercial bank's assets and liabilities were large multiples of its capital, the fact that exposures in major developing countries like Brazil or Mexico were equal to capital was seen as evidence of an emerging financial disaster. The concerns arose because the borrowing country was regarded as economically weak, "less developed" or "newly industrializing." The same or much larger multiples in foreign industrialized countries did not cause concern. In effect, it was being argued that a world financial crisis which would overwhelm the banking systems of industrialized countries would originate in developing countries — a point of view I was not able to accept during these years. The developing countries did experience severe economic and financial crises, but they did not spill over and create general financial havoc. Why not?

I find the answers in the manner in which these crises were managed. The crisis management was improvised, but sensible. It worked in 1981-84. However, it cannot be relied on to work effectively again in the next severe and prolonged downturn in the business cycle. The principle actors in this performance were the borrowing governments, the lending banks, the governments of the lending banks, and the international agencies, particularly the IMF.

The IMF expanded its role as monitor of the economic management of its member countries. After decades of such work, it was well prepared to become a counsellor to the private banks as well as to borrowing governments. It was prepared to accept the responsibilities of being the principal international instrument chosen by the creditor governments to avoid more disruption. From past activities, the Fund had earned the high regard of the various contending parties and could play the role of the honest broker. It could even take an initiative in urging and nearly insisting that banks increase their exposure significantly at a time when their country risk concerns were very strong. In such activities the Fund could count on the support of the governments of its industrialized member countries, which sustained large increases in their quotas and expanded their lending to the Fund, thereby increasing the Fund's capability to lend to its needy members. This general strong support for the

intermediary role of the IMF enabled the private banks to follow the Fund lead with much more ease and confidence. If nothing else, it meant that the official regulators or supervisors of the banks would not be likely to find fault with a bank's positive response to lending suggestions made by the Fund.

It was crisis management, but it worked reasonably well in many respects. Of key importance was the acceptance by debtors of their contractual obligations despite difficulties in meeting them fully and promptly, combined with avoidance by creditor banks of declarations of default. No one could be certain that debts would not be repudiated or that banks would not trigger defaults, but there were (and still are) many indications that it was highly unlikely.

In dealing with these issues of the 1980s, the banks and borrowing countries benefited from the recent experiences of the 1970s. In the cases of Zaire, Peru, Turkey and Jamaica, the issue of declaring defaults had been faced. Default declarations are tempting. They represent prompt protective action, not inaction or delay. In many respects, this is a safe and cautious action to take. However, the attractiveness of this course of action diminishes when one considers how little it can accomplish in cases where external payments difficulties have led to delays in debt servicing. Pragmatism and common sense have prevailed. A bank wants to prevent losses from its lending; and the banks have learned that the default/repudiation route means losses for them and much reduced chances of future recovery. And without such default declarations, the borrowing country would have better prospects of regaining its creditworthiness and becoming again an incremental borrower. Debt rescheduling was, like workout situations in domestic credit, well worth the effort. Rescheduling was a form of loan negotiation — a familiar terrain for lenders and borrowers.

Another lesson learned by the banks in the 1970s was how to collaborate in these debt cases. The banks had learned how to come to common views on thorny issues, how to deal as a collective group with a single debtor country (and its advisors), and how to deal with the IMF and other bodies as a group. Many hurdles could be expected to exist, but they were part of the job of renegotiation and rescheduling. The crises of 1982/83 seem to have strengthened the mechanisms for cooperation and collective action.

The banks' willingness to renegotiate, rather than declare defaults, was made possible by the attitude of the borrowing countries,

which accepted in practice that whatever difficulties they had in servicing their external debt, they would not repudiate their debts nor do the equivalent through indefinite moratoria on payments of interest and principal. It meant that the lending banks could hope in the longer run to recoup any short-run losses and to protect the financial strength of their institutions. It enabled bank regulators to see positive outcomes despite existing difficulties. The no default/no repudiation approach was the keystone in the crisis management. It made possible the renewal of international lending to developing countries. It provided a firm piece of ground for debtors and creditors to stand on. There have been many cases of temporary "stand-stills," moratoria, or other forms of delay in debt servicing, some extending over a year, but debtors continue to recognize their obligations and also the related obligation that creditors are not to suffer losses because of delays. Terms and conditions of negotiated debt and new debt are at times controversial. Equitable answers are not obvious. Yet these are straightforward aspects of financial business relations with many less implications than threatened repudiation or default. The simple fact is that there have not been repudiations or defaults despite serious payments difficulties.

The experience of the 1930s, when a world economic crisis was accompanied (and deepened) by a world financial crisis, was repeated in the 1980s. But the Great Depression model has proven not to be the prototype for the 1980s as expected.

Another lesson is more subtle and harder to articulate. The 1981-84 management has been crisis management, improvisation by experienced institutions and people, which has seemingly performed well. But the same improvisations may not be good enough for the problems raised during the next severe economic downturn. The strengthening of institutions can now be undertaken to improve on the existing mechanisms and practices. We have not evolved well considered, tried institutional practices to deal with the international financial effects of a business downturn. We now have the experience to do so. However, the time left to do so may be short.

Following are some suggestions for improving the existing mechanisms, to help prepare for the next cyclical downturn.

1) *Strengthen the IMF by greatly increasing its resources:* These increases give the IMF more financial resources to help members; they also demonstrate the support of members for the IMF and the

code of international monetary behavior embodied in its Articles of Agreement, policies and practices. The IMF should be large enough to assure that member countries in balance-of-payments difficulties can avoid using restrictions on international payments (other than for capital flight) or trade restrictions. In addition, member countries should be able to avoid making their currencies inconvertible and using multiple currency practices. The IMF also needs the authority to assure an exchange rate system that members regard as internationally neutral and fair, and it needs the resources to help developed countries to avoid trade and exchange restrictions for balance-of-payments purposes.

One critical way of enhancing the IMF's resources is to increase the quotas of member countries. The quota increases can be general, applying to all members, or selective. The IMF can also increase its resources, as it has done, by borrowing from member governments either as groups (General Arrangements to Borrow) or individually (e.g., Saudi Arabia), or for special purposes like the oil facility. The Fund has not used its authority to borrow from private markets. Private funds would seem to offer the possibility of large increases in available resources within the framework of the Articles of Agreement, but experience is needed for more precise judgements.

To achieve its objectives, in my view, the IMF must be in a position to mobilize many more resources than is now the case — say, the equivalent of \$200 billion or more. In practice, only a small fraction of that amount is likely to be used. Other sources of finance are much less likely to dry up during global recessions if the international monetary system is defending international trade of developed and developing countries. The IMF's underlying mission is to maintain or restore world prosperity. If it has the wherewithal to help achieve this purpose, the need to use its own resources will be minimized. If, however, its resources are inadequate and world recessions are seen as possibly leading to world financial crises, the recessions will be deeper and longer and the likelihood of crises will be greatly increased.

2) *Expand the project finance activities and enlarge the defensive role of the multilateral development banks:* The World Bank Group and the regional development banks can be given the specific responsibility for defending agreed development programs against external adversities not foreseen by the international community. A similar

suggestion was made by the World Bank staff in the 1960s in response to a resolution of UNCTAD. The suggestion was to give the World Bank Group the responsibility for providing supplementary finance to defend development programs reviewed and agreed by the World Bank. The funds were to be provided as long-term funds similar to other development finance being provided by the World Bank Group. The proposal gained widespread support among developed and developing countries. The United States was more hesitant, as were some members of the World Bank staff, for fear it would weaken the current efforts to increase the resources of the International Development Association (IDA) and decrease resources available for project finance. These discussions helped to promote international support for increasing the financial ability of the IMF to help developing countries keep their economies growing and developing in difficult times. Although this was a positive outcome, the IMF cannot make the defense of development its primary concern. Its primary concern must be the defense of the international monetary code and, thus, the external monetary practices of its members, rather than their development programs.

Assistance in defending development would have to be additional to the regular development assistance for projects under the so-called structural adjustment loans of the development banks. The aim would be to assure that top-priority projects were not cut back because of externally induced adversities. Projects in the pipeline and new ones being contemplated could still go forward, subject to international agreement. The regional development banks could readily be a major part of this exercise. The multilateral development banks could also collaborate in finding other sources of financing to reduce the reliance on their resources. Similarly, they could play an active role in advising on domestic adjustment policies which defend development, rather than have the adjustment policies give secondary priority to defending development, as often happens. This approach would require close cooperation among the international agencies. This cooperation is not easy, but, in practice, much cooperation and collaboration is taking place. Cooperation in defense of development that included the IMF would build on existing cooperative mechanisms and experience already gained. Assuming that the IMF can provide the needed general balance-of-payments support, it might be feasible to start a program of this kind with a combined financial capability of a few billion dollars.

Less controversial is the desirability of providing much more long-term fixed-interest funding via the multilateral development banks. The expansion of their activities can overcome the obvious weaknesses of depending on medium-term finance for projects that take more time to help a country achieve greater output. All of the multilateral development banks could readily position themselves to handle a much larger volume of capital transfers. They have the needed standing in capital markets to borrow from private sources. The industrialized countries must be guarantors of their development banks' borrowings, but those banks have managed (and can continue to manage) to avoid calling on the guarantors. These multilateral banks enjoy preferred creditor positions. They continue to lend during periods of global difficulties, as in 1982/83. They can perform decisive roles in both reducing difficulties and defending sound development. Development banks should be requested to indicate how much lending and project evaluation they could handle without lowering their project evaluation standards. It is assumed that nothing would be done to imperil the strong standing of these institutions in capital markets.

3) *Encourage developing countries to increase direct (non-debt) investments in their countries:* Like some developed countries, many developing countries place significant constraints on private investment in their countries (e.g., Mexico). For example, foreign investment is often prohibited for certain sectors like mining or fuels, or is limited to minority ownership positions. Countries are now reviewing these practices, having recognized the advantages of obtaining more non-debt external financing, and they are inviting foreign investors to make inquiries and even to request exceptions. Such countries appear more self-confident and less fearful of foreign domination. Much more, however, could be done. More developing countries have to appreciate that closer ties with private sectors in industrialized countries yield benefits of increased technology and greater diversification of domestic and export production. The developing countries are playing a major role in the new global integration of production and trade. They are participating in highly sophisticated arrangements for production, trading and finance. It is probable that such activities could provide much more foreign exchange, would be much less vulnerable to externally induced adversities, and could encourage economically efficient import substitution during

difficult periods. Efforts to increase investment capital could be part of the evaluation of a development program seeking international defense for times of difficulty.

4) *Encourage the appropriate role for commercial banks:* It is critically important for many developing countries that commercial banks be able to finance the huge flows of foreign trade in goods and services and be a major source of the financing of their balance-of-payments deficits. Present debt restructuring exercises recognize this need. Unfortunately, the course of events has created conditions under which the banks have become reluctant lenders. This is an unstable situation. Banks can only be voluntary lenders, unless others take the risks inherent in lending, absolving the banks from responsibility and accountability. Since, however, the need for new incremental lending is perceived, it should be feasible to achieve again in the next year or two the conditions for more normal incremental lending. For this to happen, borrowing countries must follow policies and practices which gain for them the necessary standing in financial markets, and lenders will need to have the risk management systems which give management the needed confidence to engage in expanded lending to developing countries.

In addition, banks should be prepared to bring into their risk/reward equations the impact of other defenses described above, assuming they come into existence. If they do, there will be a major role for banks in bridging the liquidity gap from the time a country's urgent need for liquidity emerges to the time that capital from other sources becomes available. The other sources cannot be expected to act quickly. Yet their likely actions can be ascertained rather quickly. The banks can informally explore with regulators their reactions to such incremental lending under otherwise adverse conditions.

5) *Encourage developing countries to improve their access to capital markets:* In this process, the countries are likely to find additional reasons to pursue cautious fiscal and monetary policies and to maintain realistic exchange rates. In addition, it will be useful to encourage firms to be well managed and to achieve the needed reputation in capital markets. Both private and public firms in developing countries have had access to such markets. Events in 1982/83 seriously damaged this access, but it can be restored; the market

criteria are well known. High interest rates may discourage such borrowing, but much longer maturities and fixed interest rates are attractive offsets. In any case, for most developing countries, this source is limited. That fact gives added importance to the role of the multilateral development banks. These banks substitute for access to capital markets by member countries not having the needed financial standing to borrow on their own standing. Their members borrow from the development banks what the development banks have borrowed from private sources.

We live in a very pessimistic period. We have learned to be skeptical of institutions and people. We readily accept worst-case scenarios as bases for our views. But pessimism has replaced realism as the fashionable viewpoint. Realism indicates the potential for success as well as for failure. We have in hand many of the ingredients of successful defense of economic and social development. Much needs to be done to realize these favorable potentials, and it can be done. The essential requirement is to continue the urgent search for more positive approaches to meet the needs of the developing countries until new policies and practices are put in place.

## CHAPTER 4

### *Restoring Bank Lending: Policies for Interdependence*

Andre de Lattre

As the world economy emerges from prolonged stagnation and the debt crisis eases, policymakers face new challenges as well as opportunities to create the conditions needed for sustained growth. Confidence has not yet been fully restored; it will take more time and structural reforms beyond the adjustment efforts now under way in many developing countries.

If governments fail to carry out reforms on a sufficient scale, many major developing countries, which are now experiencing debt servicing difficulties, will be prone to crisis for many years to come. There will be a risk, if not a major international financial catastrophe, then of an extended period of decline or, at best, stagnation of international trade. The vulnerabilities of the system were clearly demonstrated during the recession of the past three years. The World Bank has estimated that in 1982/83, developing countries cut their imports from industrialized countries by \$43 billion compared to the previous year. Such cuts in imports necessarily limit growth potential.

The other way of looking at this import reduction is to say that many countries have made substantial adjustment efforts. The combined current account deficit of non-oil developing countries has fallen from \$110 billion in 1981 to \$67 billion in 1983. As a result, many economies now have nearly sustainable external deficits and, are thus, well-positioned for recovery.

Even with reasonably strong export growth, however, the debt service burdens of some of these countries seem likely to return to excessive levels in 1985 and to crisis levels a few years later. It is, then, vital to make the best use of the next year to achieve necessary reforms. Because of the need for change, it is an opportune moment to discuss and analyze the recent economic traumas and to assess various paths to easing balance-of-payments pressures and achieving sustained growth. However, it seems clear that the problems are so complex that no miracle solutions can be expected. Both borrowers

and lenders, or, if you wish, the North and the South have to take bold steps to ensure a sounder, more durable functioning of the system.

### **An Unstable Situation**

Many elements make the present situation unstable, and in certain respects paradoxical.

Adjustment in the borrowing countries has been severe and has been achieved mainly by abrupt cuts in imports. Such cuts reduce investment and, consequently, the countries' future capacity to export. While the major developing countries can make some "repayment" through the trade surplus registered in 1983, a large surplus vis-a-vis the industrialized world is surely an abnormal situation and one that cannot last. Developing countries normally need deficits, not surpluses — that is, they need to borrow.

The North is disenchanted with official assistance, and suffers from "aid fatigue" which is easily explained by budget constraints, as most countries feel the need to cut their excessive budget deficits. Unfortunately, this fatigue is apparently linked to a dangerous wish for disinvolvement or isolationism.

Foreign direct investment, while remaining relatively stable for the world as a whole and certainly having been less disturbed by the floating exchange rate system than might have been feared, does not contribute much to the capital needs of developing countries. Direct investment is not directed mainly towards the most indebted countries. Moreover, prospects have suffered from the bad condition of private enterprise in developing countries where foreign investment could be expected to play a major role.

Trade financing for imports and exports, which now appears to be the most volatile part of foreign financing, has shrunk abruptly in recent years. When the situation deteriorates, foreign banks and enterprises can readily cut their exposure, and they have been doing this.

Lastly, rescheduling exercises, which are inevitably conducted in an emergency atmosphere, often cover too short a period. Lenders and borrowers should meet at rather frequent intervals to assess the environment — the pace of the recovery, evolution of interest rates, etc. — and to appraise borrowing needs. At the same time, as suggest-

ed recently by the Governor of the Bank of England, creditors and debtors could agree on a longer time span, say three years, for the rescheduling itself.

### **Encouraging Factors**

In spite of these rather gloomy aspects, there are indeed some brighter facets which justify hope and even optimism for the future.

One is the sense of responsibility and maturity with which the borrowing countries have generally undertaken to put their affairs in order. Contrary to many pessimistic expectations and in spite of some setbacks here and there, governments — some of them newly elected — have changed their fiscal, monetary, income and exchange policies, to achieve effective adjustment. This has been particularly true, of course, in the case of Mexico. But other countries are following the example. And quite a few three-year programs, supported by appropriate IMF stand-by arrangements, are now recording valuable progress.

The most striking changes made by the borrowing countries have undoubtedly been in interest and exchange rate policies. Many borrowing countries have moved away from extremely negative real interest rates and grossly overvalued exchange rates, and the policy changes are showing important positive effects. Such changes were all the more necessary because balance-of-payments difficulties often arise from excessive fiscal deficits. Foreign borrowing had allowed many governments to avoid budgetary constraints; in Latin America, the budget deficits of the three largest borrowers increased from about 7 or 8 per cent of GNP in 1979 to 14-18 per cent in 1982.

Budget deficits have led to excessive monetary expansion and excessive borrowing abroad. According to an IMF study, for the large developing country borrowers that have had to reschedule their debt, annual monetary growth was above 30 per cent in the first five years prior to the onset of debt financing problems. Countries that managed to avoid rescheduling had annual monetary growth rates of about 20 per cent. In countries that have rescheduled, inflation averaged around 30 per cent. It was less than half that in countries that did not experience such difficulties.

Overvalued exchange rates have also been widespread. An overvalued currency stimulates imports and discourages exports, and foreign borrowing is needed to finance the deficits. Moreover, over-

valued exchange rates reduce the cost of foreign borrowing and thus make external financing inappropriately attractive.

During the 1970s, the average real exchange rate of Latin American countries rose by over 30 per cent. According to an IMF study, the countries that have been forced to reschedule allowed their currencies to appreciate in real terms by more than 20 per cent in the two years prior to the onset of difficulties. In stark contrast to the cases of overvaluation have been the cases of change to export oriented growth. One example is Korea. Within twenty years, Korea transformed itself from one of the world's poorest countries, reliant on assistance from the World Bank's concessional loan affiliate, the International Development Association, into a middle-income donor to IDA. An essential key to this transformation was the decision taken in the early 1960s to switch from an inward-looking strategy to one of export-led industrialization based on labor intensive techniques. Except for a brief period during the late 1970s, the exchange rate has been used to keep Korean exports fully competitive. Another key element has been to keep manufacturing costs at minimum levels. For example, intermediate goods used in export production are granted an automatic exemption from tariffs.

Korean experience also shows rapid adjustment to the recent world crisis. In the late 1970s the economy began to display signs of stress, partly due to rapid credit creation associated with an investment boom. The combination of relatively high domestic inflation, sharply rising labor costs, and a fixed exchange rate brought about a deterioration in the competitiveness of Korean exports. From near balance in 1976-77, Korea's current account position deteriorated in 1979 to a deficit which amounted to 7 per cent of GNP.

In view of the deterioration, the government proceeded with resolute adjustment measures, including a depreciation of the currency by 17 per cent early in 1980. As a result of the adjustment measures, export volume rose by 11 per cent, as increased competitiveness offset the effects of recession in Korea's export markets. The adjustment path since 1979 has not been completely smooth, but it has been successful. By 1983, GNP growth was above 9 per cent, inflation about 3 per cent and the current account deficit at manageable levels.

The Korean experience is by no means unique. Many other countries have adjusted their exchange rates and promoted exports

actively. For instance, the trade surplus which Brazil is expected to register in 1984 will not be due, as in 1983, to cuts in imports, but rather to a definite orientation towards exports.

Lastly, export markets and terms of trade for developing countries are looking somewhat better. The threats of protectionism in the industrialized countries have not materialized to the extent feared. Economic recovery, if it strengthens, should make it easier for governments in these countries to resist domestic pressures for increased protection.

The picture, then, seems a little less gray. But these frail signs of progress should not justify self-complacency or illusory hopes. To keep control of the situation, borrowers and lenders must act, both separately and together. If there is one case in which the North and the South must share their efforts, it is indeed the management of the debt problem.

### **Policies for the Borrowers**

The sense of responsibility which the governments of the borrowing countries have displayed in the adjustment process shows how presumptuous it would be to give them advice. They know full well what they have to do, and if anything, need only some friendly encouragement.

The adjustment process takes time. For instance, restoring the competitive position of a country normally requires a currency depreciation with resulting pressures on domestic costs and prices. But it is only when these pressures are controlled that the competitive position can be restored so that the country can benefit from the recovery in export markets of the industrialized world.

Export-oriented growth also requires longer-term planning, particularly to determine where the country should specialize. Efforts should be concentrated on goods and services where there is a sustained world demand. Only in this way can fluctuation, which in a recession primarily affect non-specialized goods, be avoided or at least reduced.

Another important step is the encouragement of foreign investors. As mentioned earlier, global statistics indicate that foreign direct investment can only provide a limited contribution to the financing needs of the borrowing countries. But that should not deter them from adopting a positive attitude towards such invest-

ment. Foreign direct investment has the potential to stimulate export orientation and ease access to export markets as well as to reduce reliance on borrowed funds and so reduce the debt burden. It also has the potential to attract associated bank lending. Many developing countries have been reluctant to encourage foreign direct investment on the grounds that it reduces domestic sovereignty over the economy. Now that it has been demonstrated that borrowing has the same effect or worse, many governments may well see benefits in foreign investment.

For such reforms to take place, and to achieve progress in the painful areas of income policies, budget equilibrium, return of state enterprises to financial health, and more generally for the success in fighting inflation, time is of the essence. One way to ease the strains would be for governments to announce their intentions well in advance, with a calendar of steps to be taken over the coming months and years. In their march towards economic integration, the members of the European Common Market did not proceed otherwise. And experience showed that, once the necessary steps were announced, they in fact took place earlier than foreseen. This was the case in the early 1960s for the elimination of quantitative restrictions on trade and of custom tariffs.

When subsidies have been maintained for many years for essential consumer goods such as cereals or edible oils, they cannot be eliminated overnight, as has been demonstrated recently in some countries. A progressive reduction of such subsidies becomes credible once the first steps have been implemented. And it will also permit lenders to assess the progress of the adjustment mechanism and to liberalize their lending policies vis-a-vis the borrowing country.

### Action by the Lenders

If the responsibility of the borrowing countries now is to maintain an adjustment process already under way, the lenders on their side also have something clear to do: it is to continue lending. Lenders have to recognize that it is bank lending which will provide the necessary balancing item to the developing countries' financing needs and, as such, should proceed in a more orderly way than has been the case in the past. True, lending decisions cannot be decided *a priori*, and it is necessary for bankers to make sure that other

variables are properly in place. The projected current account deficit cannot be taken for granted, and all the efforts which have been described earlier must tend to limit it to a minimum. Neither should it be accepted that official development assistance remains in its present state of decline. Borrowers and bankers should make joint efforts to demonstrate the need for more official transfers, both bilateral and multilateral, for reactivation of export credit lines, and for an easier capital increase for the World Bank. But both sides must admit that, since official development assistance goes in a large proportion — and rightly so — to the poorest developing countries, its contribution to the solution of the problems of the major borrowing countries will remain limited.

The bankers will have to act; they will have to lend. To do so in a more appropriate way than in the past, they must at the same time develop a dialogue with the borrowing countries and accept a greater share of collective responsibility. The dialogue with the borrowers today is largely an emergency one, in the form of last minute rescheduling negotiations with little time for preparation or for medium-term perspectives. Borrowers and lenders need a more durable relationship, which could be developed through the activities of the committees created by the rescheduling advisory groups and through the Institute of International Finance. Such a dialogue could also address the more fundamental question of the cost of servicing the debt, with careful consideration of its various ingredients, such as the maturities covered by the rescheduling, or the interest rate or the spreads and fees which form the bankers' remuneration. Such discussion will raise many problems related to the financial health of the lending bank and the relationship to its capital base. Moreover, the regulatory requirement in the lending country will have to be discussed, if only because regulators on each side of the Atlantic have different attitudes regarding the treatment of interest capitalization.

In reviewing their activities, bankers will have to take account of the financing needs of the borrowers. Bankers should seek to ensure that the planned "voluntary" lending would provide at least as much money as the present "involuntary" lending. If bankers would agree to this, it would be easier to return to market conditions in determining the ultimate cost of the borrowing.

Bankers could take a number of steps to act with greater responsibility. The functioning of the interbank market could be improved,

possibly by the introduction of insurance schemes, by the broadening of its resources or by making wider use of the multicurrency clauses which exist in many of the agreements. It is interesting that a large part of the "new money" package for Brazil has been contracted in currencies other than the U.S. dollar.

Another step would be the strengthening of links with the international organizations that are active in this area. The World Bank "co-financing" procedures are a valuable means of attracting bank lending to the financing of sound projects, offering the benefit of World Bank analysis and, to a certain extent, of its "umbrella". The same can be said of the projected affiliate of the World Bank, already known as the World Bank's Bank (WBB), which could raise financing more easily than the World Bank itself (because of the latter's strict gearing ratio) and would significantly add to its lending capability.

Lastly, the bankers can help develop collective responsibility by ensuring the availability of better financial and economic information about borrowers to the small- and medium-sized banks. The need for greater information on borrowing countries, particularly on their debt, has been recognized belatedly. This has been recognized as an important task of the Institute of International Finance, which is the first collective undertaking of the banking industry. The Institute aims to supply its member banks with prompt and accurate information on the national accounts of developing country borrowers. IIF members have "on line" access to tables which cover the past decade and carry estimates for the year ahead. Over a quarter of the items on the 80-line item table refer to external debt, including short-term debt and payments arrears. And Institute teams will be visiting developing country borrowers to gather data and discuss economic policy and debt management issues with the authorities.

The Institute's membership and activities give it a unique basis for contributing to consideration of the future of international bank lending. The Institute has initiated a working party on this important subject. The working party, in turn, has designated specialized committees to deal with "terms and conditions," "legal aspects," "technical aspects" and "new institutions and instruments." Beyond its valuable technical role, the Institute is a manifestation of the banking community's desire to remain active in the complex and troublesome field of developing-country debt. The banks will have to make great efforts to meet the challenge of the coming years: to be active partners in policies for harmonious interdependence.



## **PART II**

# **ADJUSTMENT PROCESS**

“Current approaches to adjustment present two major problems: they maximize the global cost of the process, and they are biased against debtor countries, which are bearing a disproportionate share of the cost.”

— Carlos Massad & Robert Zahler



## CHAPTER 5

### *The Adjustment Process\**

Carlos Massad  
Roberto Zahler

#### I. Introduction

The adjustment issue is related to certain fundamental macro-economic factors which need to be in equilibrium if undesirable and disruptive effects on the economy are to be avoided. The literature as well as policymakers have traditionally considered two interrelated areas: external and internal equilibria.

The achievement of external equilibrium refers to the balance between a country's expenditure abroad and its foreign exchange receipts, and has been perceived as a basic ingredient of a stable world economic system. It is not surprising therefore that high priority has been assigned to the attainment of external equilibrium in the design of economic policy by international institutions and others which take a global, multilateral perspective. The gold standard, prior to the Great Depression, had a built-in mechanism purporting to push individual economies quickly toward continuous equilibrium in their balance-of-payments accounts. If a country tried to spend more than what it sold abroad, its gold holdings would decrease, diminishing the banking system's capacity to lend, thus increasing interest rates, depressing domestic residents' spending, stimulating exports, curtailing imports, and, therefore, restoring foreign payments equilibrium.

The system developed at Bretton Woods was also designed with the international economy in mind, attempting to obtain external equilibrium at the country level through the implicit fiscal and monetary discipline associated with the maintenance of fixed exchange rates. That process was to be complemented and smoothed by the

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IMF's financing facilities, access to which was linked to and conditioned by the country's implementation of adjustment policies to restore balance-of-payments equilibrium.

But at the same time, in the forties, nationalist tendencies, the impact of the Great Depression and the "Keynesian revolution" gave high priority to the goal of internal equilibrium. The objective was to run national economies at their maximum output potential, which meant aiming at full employment of resources and particularly of labor. Fiscal policy would play a major role in the attempt to equalize *ex ante* savings with investment flows, complementing private sector economic decisions so as to generate sufficient "effective demand" to buy the output associated with full employment of domestic resources.

In the late fifties and sixties, although in advanced countries unemployment remained at low levels, slow but steady inflationary pressures and foreign payment imbalances stimulated the development of a policy mix — a combination of monetary, fiscal, and to a lesser extent, exchange rate and commercial policy tools — aimed at the simultaneous restoration of internal and external equilibrium.

In the early seventies, industrialized countries, and particularly the United States, experienced a slowdown in productivity, stagflation and mounting balance-of-payments problems which — together with floating exchange rates, huge increased in energy prices, speculative capital movements, inflationary expectations and indexation — undermined the adequacy and relevance of traditional economic policy and analytical tools.<sup>1</sup>

Macroeconomic policy in LDCs, since the end of World War II, tended to follow a pattern similar to the one described above, with one major difference: development objectives and strategies to accelerate economic growth have had such high priority that, in general, external and internal disequilibria have been present all along. Latin America's experience from the fifties to the mid-seventies has been quite revealing: recurrent balance-of-payments crises and foreign exchange bottlenecks as well as chronic inflation have been the norm rather than the exception in a number of countries in the region. Explanatory hypotheses for these situations have ranged from those that stress that they are the consequence of structural disequilibria inherent in LDC's economies, to those pointing to basic flaws in economic policy design, with "excessive" government intervention, "repressed" inflation, erroneous pricing

policies and inefficient protectionism. In any case, the countries have had to shift back and forth from policies attempting to solve cumulative foreign, fiscal and monetary disequilibria to those which aim to run the economy at its full potential, in order to better the standard of living of the region's increasing population. As a consequence of these "stop and go" policies, the stability of the development process and the flexibility and efficiency of adaptation to external and domestic shocks have been seriously undermined for the region's economies.

The seventies witnessed a succession of events that made the situation yet more difficult. Privatization of international financial relations, a process which was already under way some years before, accelerated with the first oil price shock in 1973. The booming role of private banks, at the expense of official international financial institutions (especially the IMF and the World Bank) stimulated Latin America — perhaps the most natural client of the banks — to finance huge current account deficits. To a certain extent, the region put financing above adjustment of external imbalances during the seventies.

After the second oil shock, this process came to a halt in the early eighties, when the effects of the world recession — the most severe since the thirties — the deterioration of LDC's terms of trade and soaring international interest rates created serious debt service problems which were amplified by reduced capital flows to debtor countries as a consequence of banks' procyclical behavior. These events have led to a bleak scenario, in which, especially for LDCs, the ways out of the crisis are few and very costly. Given the magnitudes of debt involved, the external financing constraints and the new international and domestic circumstances, a reassessment of the roles of adjustment and financing is required.

## **II. Analytical Considerations**

Internal and external disequilibria, although interrelated, have usually been studied separately. Analysis and policy recommendations on these subjects tend to overlook countries' interdependence. While this may be a convenient approach when considering "small" countries and/or when there are no generalized payments or trade problems, it may otherwise lead to partial and sometimes erroneous conclusions.

The internal disequilibrium has generally been analyzed for a closed economy or under the assumption that no problems arise in the foreign sector of the economy. It usually refers to a situation where the output gap — the difference between the optimum and actual level of economic activity — is larger than some normal, natural or structural rate. In other words, when unemployment of resources — especially labor — reaches some critical value, the economy is faced with an internal disequilibrium, which is assumed to be caused by an excess supply of goods (or savings exceeding investment) and/or by distortions and imperfections in labor markets. Depending upon which of these interpretations prevails, action tends to be centered on fiscal instruments and/or on wage and indexation policies.

Another sort of internal disequilibrium corresponds to inflation. Although structural considerations may be very important, this situation is generally characterized by an excess supply of money. Therefore, policy recommendations revolve around the control of “excessive” internal credit flows (to both the public and private sectors) or around control of the determinants of the liquidity ratio — mainly inflationary expectations and the “management” of certain key prices, such as the exchange rate, wages and interest rates.

The external disequilibrium is related to an imbalance in the foreign sector of the economy. Specifically, when the current account is in deficit (or surplus), it means that a country is spending on foreign goods and financial and non-financial services more (or less) than what it receives from abroad. Until recently, the literature has focused the analysis on the trade account, assuming away as exogenous the developments taking place in the financial area. For LDCs this may have been justified during the fifties and early sixties, when direct foreign investment and official capital movements represented the bulk of the capital account of the balance-of-payments. In that context, the elasticity and absorption analyses of the balance-of-payments stressed the effects of devaluation and movements in national income, respectively, on the balance-of-payments (narrowly defined). The integration of these two analytical approaches attempted to trace the “impact” and “multiplier” effects of changes in the determinants of exports and imports of goods and non-financial services on the balance-of-payments and on the level

of economic activity and employment. The analysis allowed, under certain restrictive assumptions, for the simultaneous presence of internal and external disequilibria, and it was recognized that non-dilemma cases were the combination of unemployment and surplus in the trade balance (expansive monetary and fiscal policies being called for) or of inflation and deficit (which required restrictive monetary and/or fiscal policies). The combination of unemployment and deficit on the one hand, or inflation and surplus on the other, were perceived as dilemma cases which required additional policy tools such as changes in the exchange rate.

The recent revival of the monetary approach to the balance-of-payments shifted the focus from the trade account to the overall balance-of-payments, concluding, under the theoretical assumption that the main developments in the foreign exchange markets respond to disequilibrium in the domestic money market, that "the current account does not matter." In other words, balance-of-payments flows are interpreted as one of the main mechanisms to restore equilibrium in the monetary sector. Policy instruments emphasize the control of domestic credit (rather than the more "direct" determinants of exports and imports), so as to accommodate it to money demand in such a way as to generate a desired balance-of-payments surplus or deficit; the latter would reflect excess supply of or demand for local money. The precise way in which domestic residents try to satisfy their money demand — by offering goods or real or financial assets abroad — would be of minor importance. Adherents to this approach, which prevailed in many countries during the seventies, argued that little importance should be given to the huge inflows of financing to some LDCs, since it represented the "natural" response of domestic agents to an excess demand for local currency.

The magnitude, nature, and persistence of recent external imbalances and their relation to domestic disequilibria suggest that stylized standard theoretical models of balance-of-payments analysis rely on different sets of unrealistic and quite restrictive assumptions, and have provided partial and sometimes erroneous interpretations and policy recommendations. In particular, analysis of the determinants of private international financial flows and of the impact of foreign debt on the domestic economy has been scanty. Also, policy prescriptions, given the *ceteris paribus* assumption in relation to world economic activity, international interest rates, etc., put the burden of restoring equilibrium on the "problem country," with

little or no recognition of the interdependence among countries both in causes and responsibilities for external imbalances. An attempt to construct another theoretical synthesis exceeds the scope and purpose of this paper; we will instead concentrate on certain analytical issues which seem especially instructive about present foreign imbalances, about alternative options, and about more realistic and efficient policies.

A country's deficit in the current account of its balance-of-payments responds to the fact that domestic residents' expenditure exceeds their income. This may correspond to a case where *ex ante* (desired) investment exceeds public and private domestic savings, requiring foreign savings to close the gap. Under certain conditions and within bounds, this process can be sustained for long periods of time.

This has been the traditional situation observed in most LDCs that are net international debtors. Since "young" developing countries have a lower capital-labor ratio and higher returns on investment than advanced countries, it tends to be in the interest of both to transfer resources from relatively capital-intensive countries to LDCs.

The basic factors which determine the stability and regularity of net inflows of capital to LDCs are the availability of international financing and the creditworthiness of the country. The former element is independent of the country's economic policy, and the latter is usually related to the way in which the country incorporates foreign savings into its economy. If borrowing is used to maintain or increase consumption or to finance low-return investments, not only will the country's creditworthiness be affected negatively, but forthcoming debt service payments instead of taxing future growth of income will force a reduction of consumption levels in the years to come. On the other hand, the higher the complementarity between foreign and domestic savings and the more foreign savings are used to increase productive capacity, especially in the tradeables sector, the better will be the evolution of the traditional creditworthiness indicators. However, in spite of "sound economic management," creditors may tend to reduce their loans if outside factors (such as an increase in international interest rates or deterioration in the terms of trade of debtor countries) affect their evaluation of the country's debt servicing capacity negatively. Naturally, this process by itself tends to make the debtor's balance-of-payments

position even worse. It should be clear, therefore, that a regular flow of foreign savings may unexpectedly and quickly turn into a foreign exchange bottleneck and an urgent problem in economic policy management, and, what in other circumstances might have been a "normal" deficit may turn out to be an external disequilibrium "problem."

The determinants of the current account developments may be classified as external factors (in the sense that individual countries are not responsible for and may be unable to offset them) and internal or domestic factors, which can be attributed to consequences of the country's policy actions, or omissions, affecting its international competitiveness and overall foreign payments situation. Naturally, this distinction is neither exhaustive nor precise or rigorous. However, it may shed light on the role these factors have played or may play in the future, and it may suggest more efficient and equitable strategies to face the problem at the country and international levels.

The main external factors negatively affecting the current account are a deterioration in the terms of trade, reduced demand for LDCs' exports by advanced countries and increases in international interest rates. Fluctuation and procyclical behavior of capital flows to LDCs can also decisively worsen an external imbalance by reducing the availability of foreign financing to face a given deficit on current account.

Besides supply shocks, which although domestic in nature are in a sense "exogenous" to policy makers, two main internal factors can be distinguished that may exacerbate foreign payments disequilibria. On the one hand, aggregate demand management may stimulate excessive spending by the public and/or private sectors. On the other, relative price movements may stimulate non-tradeable goods supply and tradeable goods demand — through exchange rate, commercial interest rate and income policies — contributing to a loss in international competitiveness. An intermediate situation, which recently has been quite important in some countries, relates to the combined implementation of financial reforms and stabilization programs resting on exchange rate overvaluation. This may lead to domestic policy inconsistencies which end up in a direct stimulus to aggregate demand and current account deficits through the monetization of financial flows stimulated by expectations of speculative capital gains.

The above classification, while it helps to explain the factors relevant to an external disequilibrium, should be complemented by the consideration of two additional elements. The expected time dimension of the shock, whether foreign or domestic, plays a crucial role when evaluating alternative solutions: temporary effects should be distinguished from permanent ones, although this is sometimes difficult to determine. Another useful distinction is between shocks of "real" and of "monetary" nature. Examples of the first may be found in losses in productivity, obsolescence in technology or "real" terms of trade deterioration (such as the one caused in oil-importing countries by the successive increases in fuel prices). Monetary shocks are typically derived from money market disequilibria. For example, if money supply continuously exceeds money demand, attempts to improve the balance-of-payments position through a once-and-for-all devaluation will be inefficient and should be complemented by policy tools addressed to the control of domestic credit expansion.

From the perspective of accounting, external imbalances (in a country whose currency is not accepted as international money) have to be financed by running down gross foreign exchange reserves or increasing the stock of foreign debt outstanding and the level of payments arrears, or some combination of these. However, an *ex ante* disequilibrium in the external accounts may be substantially larger than the imbalance which is finally financed, the difference being wiped out through adjustment of the imbalance by domestic policy measures designed to produce an expansion of exports of goods and services, a reduction of imports, or some combination of both so as to reduce the projected current account deficit and the consequent need for additional foreign finance.

Adjustment measures typically have focused on expenditure reducing and expenditure switching policies. The former consist in restraining aggregate demand via restrictive monetary, fiscal and/or income policies (including lower wages and higher interest rates), with the objective of directly reducing domestic spending on tradeables. Increases in the exchange rate also work in the direction of reducing domestic spending through their effect on the real money supply, at least in the short run.

Expenditure switching from tradeable to non-tradeable goods is accomplished through relative price changes, typically exchange rate movements, changes in tariffs and other import regulations, and various forms of export subsidies. These policies may be used to

depress domestic spending on tradeables and to stimulate resource allocation towards production of tradeables.

If adjustment could be promoted rapidly through changes in relative prices, its cost in terms of output foregone and higher unemployment might be quite small. However, real resource transfers between sectors and regions take time. Lags and inertia in factor mobility, rigidity in prices and wages, and uncertainty regarding the temporary or permanent nature of the policy changes may induce those sectors motivated to contract by price stimulæ to do so rapidly, while those stimulated to expand generally take a long time to do so. In the process, global output suffers, unemployment and inflation rise, and real wages are negatively affected. Furthermore, traditional policies have placed greater emphasis on reducing aggregate demand than on increasing output and changing its composition; therefore, if spending is reduced as part of the program, there will be an added impulse to losses in output and increases in unemployment. Experience has shown that, as both relative price changes and expenditure reductions are promoted by the authorities of the debtor countries, the process involves unemployment and output losses which take a long time to disappear. Adjustment, in the sense of a reduction in the external imbalance, may occur relatively rapidly, but at a substantial, and prolonged, economic and social cost.

When an adjustment process takes place in a stagnant world economy and when current account deficits are localized not at the country level, but at a regional level, the recessionary effects of adjustment policies tend to be aggravated. This is true for individual countries because of the lack of foreign demand for their exports, which necessitates huge relative price changes (with the above mentioned associated costs) to better their trade balance. It is also true internationally, since, due to the importance of LDCs in world trade and payments, when a region as a whole curtails its imports, it will slow down the recovery of advanced surplus countries. Similarly, when many countries are induced to increase their exports, this will not only tend to deteriorate their terms of trade but will also create increasing resistance and protectionism in developed countries, further worsening the prospects of recovery in LDCs.

Because of these difficulties, countries often opt, and should opt, for financing their current account deficits, which ultimately

means delaying adjustment for the future.<sup>2</sup> The two components of the settlement of an external imbalance — adjustment and financing — are frequently interrelated. In most cases of a large *ex ante* external deficit, voluntary financing can be obtained if, and in some cases only if, adjustment measures are taken that reduce the need for financing to what creditors consider “manageable” or “credible” proportions. In fact, the International Monetary Fund makes its regular resources available over certain limits only if the country in difficulty implements adjustment policies designed eventually to eliminate the deficit.

It is not obvious whether an imbalance should be financed or adjusted, since the answer depends on the nature, magnitude and persistence of the imbalance as well as on the availability of financial resources to the country in question. An imbalance originating in factors which are of a transitory and monetary nature, expected to last for a short period of time, should generally be financed; this conclusion is derived from efficiency criteria. In turn, a deficit emanating from real and/or permanent changes in the economic environment or from facts which, while transitory in character, are expected to last for a prolonged period of time, requires adjustment.

From another perspective, when external factors predominate, it seems reasonable on grounds of equity and sometimes efficiency to argue in favor of financing. Again, this is especially true when the external disturbance is perceived as temporary and is of a “monetary” nature (i.e., the increase in world interest rates), and less so when it appears more permanent and is based on “real” factors (i.e., the increase in oil price).

However, it is not always easy to determine at an early stage whether permanent and transitory or monetary and real changes are at work. So, rather than a “fundamentalist” approach to external imbalance, a cost-benefit approach is usually taken to determine the policy instruments to be used in facing a disequilibrium in foreign payments. Financing a deficit has costs measured in terms of future debt burden, while adjustment implies some current real income foregone and a transitory increase in unemployment and inflation.

The usual “small country assumption” about foreign financing is that there is an infinitely elastic supply of foreign credit; the borrowing country determines the amount borrowed per year, at

the going interest rate and other costs. In this case, the amount of indebtedness per year is essentially demand-determined, while supply conditions determine the cost of borrowing. This assumption is a useful one when international financial markets are growing rapidly, as they did up to 1981, and when "country risk" perceptions of the creditors do not limit the supply of external credit to borrowing countries. As financing reaches its maximum limits, a country is not in a position to evaluate cost and benefits of alternative ways of settling the imbalance: it is forced to adjust, whatever the costs. Under these conditions, it is not surprising to find that in many cases of external imbalances, countries act unilaterally in the financing area, through arrears in commercial and other foreign payments; such action may properly be dubbed "involuntary lending."

### **III. Financing and Adjustment: Recent Tendencies and the Current Situation**

As is well known, world financial markets expanded at a rapid rate during the 1970s. Total assets of banks reporting to the BIS expanded at an average rate of 25 per cent during the period and in no year at less than 19 per cent. Between 1973 and 1981, the net flow of banking credit to non-oil LDCs increased more than fivefold, from US \$10 billion to its peak of more than US \$50 billion in 1981.

This rapid growth is explained by both institutional and structural factors. Among the institutional factors, perhaps the most important is the lack of regulation in the Eurocurrency markets, including the absence of minimum reserve requirements and of mandatory maximum debt/capital ratios. In regard to structural factors, the accumulation of liquid balances under the control of oil-exporting countries is clearly one of the most outstanding characteristics of that period, from an international financial point of view. If oil-exporting countries had decided and been in the position to accumulate real assets rather than liquid funds, the latter would have gone back to the suppliers of real assets, and the expansion of the financial market would have depended on their preferences of portfolio composition.

Of course, at the root of the expansion of financial markets is the working of the international monetary system. Asset rather than reserve currency settlement would have allowed a more mod-

erate, regulated expansion of reserve currency holdings outside the country of issue.

In any case, rapid growth of financial markets during the seventies created an international capital market largely outside the regulatory control of any monetary authority or international institution. Capital movements have become more and more important in the international payments and exchange rate determination, and consequently private sources of finance — especially banks — have increased their importance while the role of official institutions and governments has weakened in an increasingly market-based monetary and financial system. This has resulted in turn in a sharp reduction of the average maturity of loans and in substantial increases in the cost of borrowing for LDCs, especially those of Latin America.

By the end of 1981, and particularly in 1982, the growth of the financial markets slowed dramatically, in the wake of the breakdown of the oil cartel, on the one hand, and of the increased perception of risks by international lenders, on the other. In those years, while capital flows to LDCs slowed, banks also increased their spreads, fees and commissions and shortened the maturity of new loans.

The rapid growth of debt, implicit in the rapid growth of credit, can be sustainable, as long as the debt burden does not grow out of proportion with GNP and exports. This seemed to be the case in a number of Latin American countries during the seventies: Mexico, for example, averaged 6.4 per cent growth in real GNP from 1970 to 1979 while its exports grew in real terms by 10.9 per cent annually. In the same period, comparable figures for Brazil were 6.7 per cent and 9.1 per cent. Argentina had a less enviable annual growth, 2.6 per cent, but still expanded its exports by 10.7 per cent per year.

However, a deterioration in the terms of trade of debtor countries or an increase in international interest rates could make the debt burden unbearable, and that was what happened in the early 1980s. Although it may be said that many countries in Latin America did not adjust to the two oil shocks of the seventies and incorrectly perceived the growing external financing available during the decade as stable and permanent, it can also be stated that for many countries the debt service crisis was due less to mismanagement or unwise borrowing and lending than to high interest rates and a world recession that reduced export earnings.

Table 1

**Evolution of International Economic Indicators  
Affecting the Balance of Payments of  
Latin American Countries: 1965-1983**

	Terms of trade of Latin America a/		Real interest rate b/ (%)	Indust- rialized countries' growth rate c/ (% change)	Net inflow of capital	
	Total	Non-oil export- ing countries (% change)			Billions of nominal dollars	Billions of 1983 dollars d,
Average 1965-1972	.3	.2	2.82	4.6	3.4	8.8
1973	13.4	10.6	2.94	6.2	8.1	18.3
1974	15.8	--7.0	.11	0.1	11.6	23.5
1975	--13.5	--12.0	--2.21	--0.7	14.5	27.3
1976	4.6	7.4	--0.22	5.3	18.3	32.0
1977	6.0	10.7	--0.50	4.3	17.3	28.5
1978	--10.5	--10.2	1.23	4.5	26.4	40.3
1979	3.5	--6.7	0.66	3.5	29.0	39.7
1980	4.2	--7.2	0.86	1.1	29.9	36.1
1981	--7.3	--13.0	6.11	1.5	38.0	41.5
1982	--7.0	--7.6	6.91	--0.4	16.6	17.1
1983 e/	--7.2	--1.6	6.71	1.8	4.5	4.5

a/ From 1970 on excludes Venezuela, Bolivia and Ecuador; from 1976 on excludes also Mexico and Peru.

b/ Refers to three month Eurodollar London interest rate minus United States inflation, as measured by the Consumer Price Index (CPI).

c/ GNP growth rate of Canada, United States, Japan, France, Federal Republic of Germany, Italy and United Kingdom.

d/ Deflated by United States Consumer Price Index Inflation.

e/ Preliminary estimates. Data for interest rate and United States inflation cover up to October 1983.

Sources: ECLA, *Estudio Economico de America Latina* 1982; *Sintesis Preliminar de la Economia Latinoamericana*, 1983; IMF, *World Economic Outlook*, 1983; OECD, *Economic Outlook* 1972; IMF, *Balance of Payments Yearbook* (various issues).

As a consequence of domestic economic policies in industrialized countries, the rate of growth of the world economy came to a halt in 1982, real interest rates in international markets soared, and protectionist tendencies in advanced countries increased; at the same

time, terms of trade moved rapidly against debtor countries, including oil-exporting ones. As the recession took hold, both the domestic and international portfolios of banks in industrialized countries suffered. In LDCs, this process of bank portfolio deterioration led to financial crisis in several cases, which compounded the portfolio problems and risk perception of international lenders (see table 1).

It is worth noting that domestic policies in some LDCs also stimulated the accumulation of debt through inconsistent financial reforms and exchange rate movements (devaluing at rates substantially below domestic inflation). High inflationary pressures and high interest rates in domestic credit markets, as well as tight monetary and (sometimes) fiscal policies, could be avoided by borrowing abroad. Furthermore, in many cases, speculative capital movements were also stimulated by huge interest rate differentials between domestic and foreign rates. For some time, this situation allowed for the simultaneous presence of current account deficits and overall balance-of-payments surpluses, a condition which could be sustained only by an increasing foreign debt.

Stimulated from both the supply and demand sides, the foreign debt increased at a pace which made the debt level incompatible with sharp or prolonged world recession. In fact, the overwhelming importance of private banking in the flow of new financing, given its commercial and risk-averse nature, has amplified rather than moderated the recessionary tendencies of the early 1980s.

Present levels of foreign debt are such that changes in interest rates in international markets have a substantial impact on foreign payments. Since an increasing proportion of the stock of LDC debt is subject to floating rates, the bulk of the stock, and not only new lending, will be affected by changes in rates. Table 2 shows the effect of a 1 per cent increase in interest rates on foreign payments in non-oil-exporting LDCs. For Latin American and Caribbean countries, the impact amounts to US \$2.3 billion, which represents 2 per cent of the region's exports of goods and services. It should be noted that this effect is substantially larger than that of a US \$1 increase per barrel of oil.

Although nominal interest rates in the United States have declined from their extreme levels of 1981 and 1982, they have fallen neither as fast nor as far as the (US) rate of inflation, and they remain far above their real historical levels for comparable stages of

Table 2

**Effect of a 1% Change in Interest Rates on  
Foreign Payments of Non-Oil-Exporting LDCs**

Area a/	Amount of debt subject to floating rates (billions of dollars) (1)	1% interest rate change (billions of dollars) (2)	Total ex- ports of goods and services (3)	2:3 (percentage)
Western Hemisphere b/	227.9	2.3	115.2	2.0
Africa	37.7	.4	54.8	.7
Asia	76.4	.8	178.4	.4
Other	73.9	.7	99.5	.7
<u>Total</u>	<u>415.9</u>	<u>4.2</u>	<u>447.9</u>	<u>.9</u>

a/ The classification of countries corresponds to IMF, *International Financial Statistics* from March 1980 on.

b/ Western Hemisphere excludes only Venezuela as oil exporter.

Source: IMF, *World Economic Outlook*, 1983.

Table 3

**Non-Oil-Exporting LDCs' Interest Payments  
in 1981-1983 by Areas**

Area a/	Interest payments (billions of dollars) (1)	Export of goods and services (billions of dollars) (2)	1:2 (Percentage)
Western Hemisphere b/	31.4	115.2	27.3
Africa	4.4	54.8	8.1
Asia	9.8	178.4	5.5
Other	10.0	99.5	10.0
<u>Total</u>	<u>55.6</u>	<u>447.9</u>	<u>12.4</u>

a/ The classification of countries corresponds to IMF, *International Financial Statistics* from March 1980 on.

b/ Western Hemisphere excludes only Venezuela as oil-exporter.

Source: IMF, *World Economic Outlook*, 1983.

Table 4			
Interest Payments and New Debt of Non-Oil-Exporting LDCs in 1982-1983			
(Billions of dollars)			
Area a/	Interest payments	Net external borrowing	Net transfer
Western Hemisphere b/	31.4	18.2	-13.2
Africa	4.4	9.0	4.6
Asia	9.8	15.6	5.8
Other	10.0	9.9	-1.1
<u>Total</u>	<u>55.6</u>	<u>52.7</u>	<u>-2.9</u>
a/ The classification of countries corresponds to IMF, <i>International Financial Statistics</i> from March 1980 on.			
b/ Western Hemisphere excludes only Venezuela as oil-exporter.			
Source: IMF, <i>World Economic Outlook</i> , 1983.			

previous business cycles. With annual interest rates at nominal levels of 12 per cent to 18 per cent (including spreads) between 1981 and 1983, interest payments consume a substantial proportion of gross export income of debtor countries. The figures are shown in table 3.

Furthermore, interest payments by Latin American and Caribbean countries in 1982 and 1983 exceeded increases in their net foreign borrowing, so that a reverse transfer of resources from debtors to creditors was under way. This would be a natural result as LDCs' economies mature, but it is a heavy burden when it is a consequence of world recession rather than a by-product of the growth process (see table 4).

High international interest rates affect not only debt service but also primary commodities, since interest rates tend to be negatively correlated with the terms of trade of primary producing countries. The burden of high interest rates is amplified by a deterioration in the terms of trade, in what has been called the "scissors effect"; the resultant squeeze has nearly caused some major debtor countries to default (see figure 1). This negative relation is explained by the

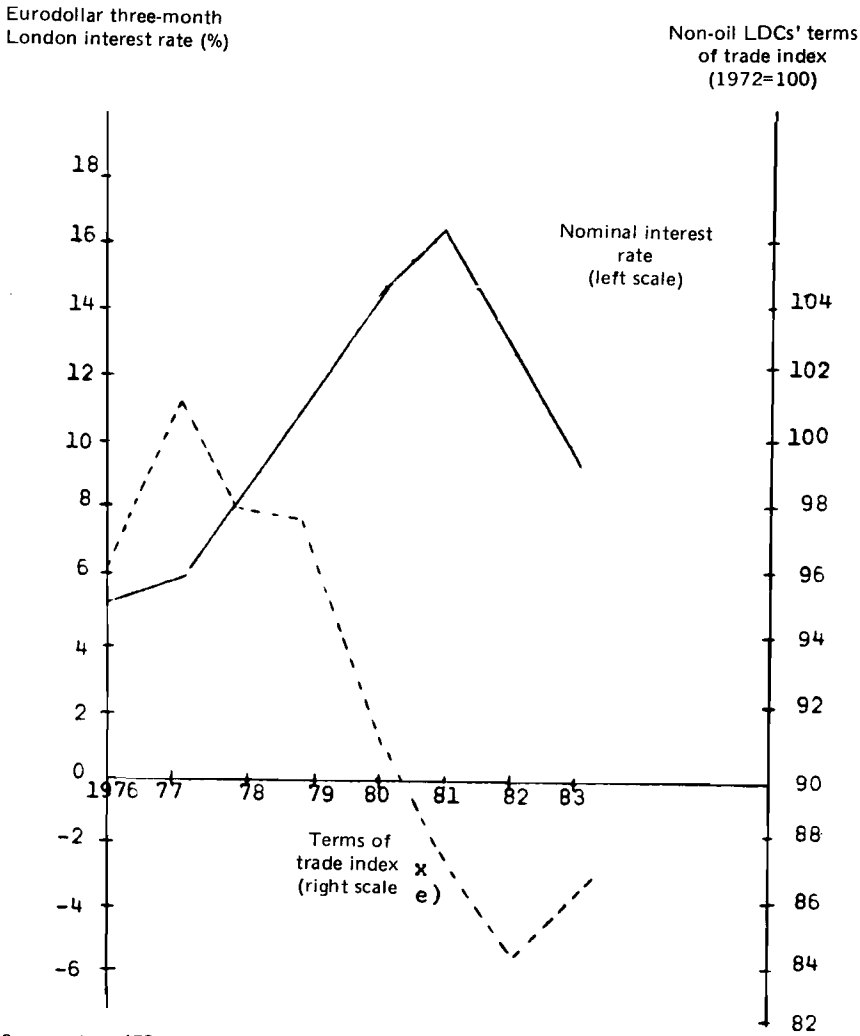
direct impact of interest rate changes on the transaction, inventory and speculative demands for primary commodities (see Padma Gotur, "Interest rates and the developing world", *Finance and Development*, Vol. 20, No. 4, December 1983). Also, high interest rates discourage domestic expenditure, so that the level of economic activity suffers and demand for primary products falls. As most of these products are sold in highly competitive markets and their supply is inelastic, prices tend to change rather sharply with changes in demand.

The recent international monetary and financial developments, the macroeconomic policies in the industrialized countries, and the world recession have been the main external factors negatively affecting LDC economies. To this list should be added some domestic or internal factors, quite common in Latin America during the second half of the seventies. Overvalued exchange rates, expansive aggregate demand policies, and stimulus to and inadequate use of foreign indebtedness have also contributed, although to a lesser extent, to the balance-of-payments crisis that started in 1981 and continued during 1982 and 1983.

The magnitudes involved and the adjustments made are quite clear and impressive. The deficit in the current account reached its peak in 1981. Since then, the trade balance changed from deficit to surplus, reaching an extraordinary amount of more than US \$31 billion in 1983, a figure which more than tripled the improvement already attained in 1982. The balance in current account before interest payments and profit remittances improved by US \$37 billion between 1981 and 1983, a figure representing about 4 per cent of Latin America's average GNP in the period. As a consequence of the changes affecting trade and, to a much smaller extent, financial services, the current account deficit contracted abruptly from US \$36.4 billion in 1982 to US \$8.5 billion in 1983, the smallest deficit since 1974 (see table 5).

One cause of this extraordinary reduction in the current account deficit was the drastic contraction in the net inflow of capital which Latin American countries suffered in 1983. This inflow, which had already been reduced in 1982 to less than half the historical maximum of 1981 (when it reached US \$38 billion), fell again in 1983 to less than US \$4.5 billion. This is why, in spite of the huge surplus in the trade account and the sharp fall in the deficit in the current account, foreign exchange reserves fell for the third consecutive year.

Figure 1  
Evolution of Terms of Trade of Non-Oil-Exporting LDCs  
And Nominal Interest Rate



Source: IMF, *IFS*, January 1984; *World Economic Outlook*, 1983.

Table 5

## External Imbalances in Latin America

(Billions of dollars)

	1979	1980	1981	1982	1983
1. Exports of goods	69.6	90.5	96.8	88.6	87.5
2. Imports of goods	69.1	91.5	98.4	78.9	56.3
3. Trade balance	0.5	-1.0	-1.6	9.7	31.2
4. Non-financial services (net)	6.5	8.5	11.4	9.6	6.4
5. Current account balance before financial services	-6.0	-9.5	-13.0	0.1	24.8
6. Financial services (net)	14.2	19.0	29.1	36.8	34.0
7. Balance on current account	-19.6	-27.7	-40.4	-36.4	-8.5
8. Net capital movements	29.0	29.9	38.0	16.6	4.5
9. Foreign global debt	166.4	205.2	257.9	289.4	309.8
10. Foreign debt services	37.1	43.2	54.6	69.2	—
<b>Percentages</b>					
11. Interest payments as a percentage of exports of goods and services	17.4	19.9	26.4	38.3	35.0
12. Current account balance as percentage of gross national product	-2.8	-3.3	-4.3	-3.9	-0.9

Source: ECLA, *Sintesis Preliminar de la Economia Latinoamericana*, 1983.

In terms of the region's imports, the reserve coefficient was reduced from an average of nearly 50 per cent in the period 1973-1979 to about one-third in the eighties, in spite of the fact that imports fell by over 40 per cent from 1981 to 1983.

The fall in the net inflow of foreign capital to Latin America, combined with the very high remittances of debt service, contributed to a net transfer of resources out of the region, for the second consecutive year, amounting to nearly US \$50 billion during 1982-

**Table 6**  
**Latin America: Cost of Adjustment Indicators**

	1976/1979	1980	1981	1982	1983
Real GNP per capita (1970 dollars)	930	1,007	997	965	911
Real GNI per capita (1970 dollars)	929	1,009	985	938	883
Changes in consumer prices (%)	50	53	61	86	130
Unemployment median a/ (%)	7	7	7	9	10

a/ The median of annual average rates of urban unemployment in 10 selected Latin American countries.

Source: ECLA, *Síntesis Preliminar de la Economía Latinoamericana*, 1983.

1983. Obviously, as a consequence of the smaller net capital inflow, the increase of foreign debt slowed: to 7 per cent in 1983 as compared to 12 per cent in 1982 and the high average figure of 23 per cent during 1977-1981. Interest payments, however, which in 1977 represented 12.4 per cent of exports of goods and services, have steadily increased, tripling that figure in 1982-1983. Furthermore, interest payments have also increased as a proportion of total debt service payments, from 35 per cent in 1977-1978 to 58 per cent in 1982 and to a much higher figure in 1983, due to the postponement of most amortizations in that year.

But despite generalized devaluations and the implementation of other measures designed to stimulate exports, most of the adjustment occurred in the form of a drop in imports, which fell 29 per cent in 1983 after having fallen by 20 per cent the year before. This extraordinary fall in imports caused, and was caused by, a sharp contraction in economic activity and other related indicators (see table 6). Latin America's GNP fell 3.3 per cent in 1983, after having fallen 1 per cent in 1982. GNP per capita fell by 5.6 per cent in 1983 and was nearly 10 per cent lower than the 1980 figure,

reaching only the level attained as far back as 1977. Gross national income fell further than GNP, since the region's terms of trade deteriorated for the third consecutive year (and for the sixth consecutive year for the non-oil-exporting countries of the region). Urban unemployment increased in almost all countries, while inflation soared to unprecedented high rates.

Perhaps the most illustrative way to portray the magnitude of what this adjustment process has meant for the region is to point out that if GNP had continued to grow at one-half its average rate of growth between 1970-1980, Latin America would have obtained US \$150 billion (real 1983 dollars) in additional GNP in 1981-1983. That amount is equivalent to nearly half the region's stock of foreign debt and to the GNP of Sweden or Switzerland.

Despite the important adjustment policies adopted by Latin American countries in 1982 and 1983, foreign exchange generated by this process and by voluntary lending was insufficient to cover external debt payments; and a number of countries found it impossible to pay not only the principal but in some cases even the interest. Most countries had to reschedule their external debt services and tried to reach agreements with the IMF and other foreign creditors to meet such debt service charges — not to mention repayment of loans coming due — and most have had to reduce internal spending and apply austerity programs to comply with IMF requirements.

Under present conditions, it cannot be expected that debt will continue to grow as in the past. While the flow of liquid savings has been reduced substantially, lenders are taking an extremely careful and selective attitude regarding international operations. In fact, as mentioned, the expansion of international lending in 1983 has been very much lower than interest accrued on the debt, so that the transfer of real resources from debtors to creditors has reached unprecedented levels, even after allowing for debt renegotiation and for the fact that there are now considerable arrears in interest and amortization payments of some debtor countries. While total international assets of banks reporting to the BIS grew by US \$22.3 billion in the first six months of 1983, as compared to US \$74 billion in the same period in 1982, bank lending to Latin America increased by US \$3.7 billion (US \$12 billion in the first semester of 1982), and lending to all LDCs went up by US \$5.8 billion (US \$15 billion in the first semester of 1982).

So, regardless of the transitory and externally caused nature of the present deficits in foreign payments of Latin America, due mainly to unusually high foreign interest rates and unusually unfavorable terms of trade, financing is playing a very limited role in closing the external gap. Traditionally the IMF, in its conditional lending, included provisions to eliminate involuntary lending, offering financial resources in exchange. However, when imbalances are big enough, as they have been in 1982-1983, IMF resources are not sufficient; thus the Fund has been actively promoting the provision of additional funding from private lenders to complement its own very limited financing possibilities, in order to try to avoid a payments crisis.

As already mentioned, banks have reacted very conservatively, trying to reduce their exposures in LDCs. The availability of financing is now an extremely binding constraint for those countries. But in spite of the new circumstances, the IMF is playing its usual role of treating causes of and cures for individual country balance-of-payments crises as if they were isolated phenomena. This time, however, financial shortages have required an extremely restrictive and costly adjustment process, which has been determined not by the nature or causes of the imbalance, but rather by the availability of financing. The latter has overridden cost and benefit considerations; that is to say, the cost of financing has become infinite above some limited amount.

#### **IV. Adjustment and Debt in the Eighties: Options and Limitations of Existing Tendencies, Institutions and Practices**

##### *The International Scenario*

Until the second half of 1980, developments in the foreign sector of Latin America's economy seemed to be perfectly under control. It is clear from the preceding sections that, beginning in this decade, shocks originating in policy actions of the industrialized countries and in the world economy played a major role in the generation of external imbalances in LDCs. In 1983, if terms of trade in Latin America had been similar to those prevailing in 1980 (25 per cent better) and if international interest rates had been similar

to those prevailing when the bulk of foreign debt was contracted (on average four percentage points below present rates) an additional US \$25 billion would have been available to the region. With these resources, the region would easily have fulfilled its foreign payment obligations without having to reduce its imports dramatically and without accumulating additional foreign debt. In other words, if world trade and finance would return to "normal" conditions, Latin America's foreign payments commitments could be satisfied without sacrificing its consumption levels or its growth possibilities. Thus appropriate policy measures in the North are now a crucial element for the viability of the adjustment processes taking place in the South.

Of course, policies in LDCs have had a degree of responsibility in creating imbalances, but the correction of such policies has already been achieved — to excess in many places, with painful effects on both the domestic economy and the social fabric: it is questionable whether these countries will be able to sustain the effort.

Current approaches to adjustment present two major problems: they maximize the global cost of the process, and they are biased against debtor countries, which are bearing a disproportionate share of the cost. There are four major aspects of the international economy where action is needed to reverse this situation.

First, high and volatile interest rates have a definite negative impact in the current crisis. As already mentioned, debt service payments and terms of trade of LDCs have been adversely affected. Interest payments exceed the cost of oil imports in non-oil LDCs. In addition, interest rates have contributed to the delay of recovery in the North and have helped to strengthen the value of the dollar *vis a vis* other currencies, through capital inflows to the United States. This has affected LDCs' competitiveness and has increased the real cost of servicing foreign debt, which is predominantly denominated in US dollars. In relation to this latter point, it has been estimated that if non-oil LDCs' borrowing from commercial banks — which amounted to about US \$150 billion between 1979 and 1982, virtually all in terms of dollars — had diversified to correspond broadly with the currency composition of their trade, combined savings for these countries, in terms of lower interest costs and exchange rate gains, would have amounted to over US \$30 billion (see A. Mohl and D. Sobol "Currency diversification and

LDC debt," Federal Reserve Bank of New York Quarterly Review, Autumn 1983, Vol. 8, No. 3). Furthermore, high interest rates (together with overvalued Latin American currencies) have stimulated capital flight to the United States, which, according to private bank sources, reached US \$100 billion during 1980-1983, aggravating the region's debt problems.

Macroeconomic policies in industrialized countries, and especially fiscal policy in the United States, have a major responsibility in high and uncertain interest rate levels. Monetization and crowding-out effects of the fiscal deficits, expectations that the United States deficit is unlikely to disappear even with a strong, enduring recovery (since spending growth for both social and defense programs will outpace the increase in tax revenues), and the global competition of industrialized countries' public sector deficits for a relatively weak flow of global savings are the major factors behind recent interest rate levels and movements. And the impact of international interest rates on LDCs is bigger than their effect on the average borrower in the United States or the United Kingdom, since American or British borrowers can write interest rate payments off against taxes.

It should also be noted that banks' earnings depend not so much on the level of interest rates as on spreads, so that in principle the soundness of the banking system would not be at stake and could even be enhanced if real interest rates could be reduced.

In summary, advanced countries' responsibility for the levels and fluctuations of interest rates — one of the main determinants of current balance-of-payments crises and of the costly and inefficient adjustment process in LDCs — should be clearly recognized, and action should be taken regarding the fiscal and monetary policy mix and regarding coordination of these and exchange rate policies among industrialized countries.

The second international factor to consider is that the actual adjustment process, based on generating trade surpluses in debtor countries, is being made extremely difficult and costly by the lack of sufficient foreign demand and by protectionist tendencies in the North, which have affected both the exports and the terms of trade of LDCs. On average, LDCs' products account for only 3 per cent of the industrialized countries' market. This relatively small share leaves ample scope for further expansion. However, large shares for some specific products, and the protectionist measures against

imports of these, may mean there will be only moderate expansion ahead. Although it should be noted that protectionist measures in OECD countries did not suppress the dynamism of the most successful exporting countries in the late seventies, the export environment in the next years will be much more competitive than that in the last fifteen years. In addition to export promotion policies on the part of debtor countries, strong export growth will require both a healthier world economy and a restructuring of the industrialized countries' economies — an essential aspect of international economic development to which national policies in both industrialized and developing countries must make a positive contribution (see B.A. de Vries, "International Ramifications of the External Debt Situation", the AMEX Bank Review Special Papers No. 8, November 1983).

Although developments in 1983 and forecasts for 1984 indicate a recovery from the 1982 world recession, and despite the increase in imports into the United States, the international transmission of the recovery is working less well than in the past. The growth of world trade exceeded the growth of world output by a sizeable margin in the two-year period following the 1975 recession, as it has on average throughout the postwar period. For 1983-1984, in contrast, the excess of trade over output growth is likely to be negligible or non-existent, mainly because of less available financing, the proliferation of protectionist measures, and the restrictions imposed on imports by heavily indebted LDCs.

In a dynamic, expanding economy, traditional prescriptions for a single country to adjust by increasing exports and restricting imports may make sense. However, since every export is someone else's import, a "composition fallacy" may occur in case of a generalised crisis. Since the IMF has leverage with respect to deficit countries, which are in need of financial resources, and not with respect to surplus countries (or reserve currency countries, whether in surplus or deficit), the burden of adjustment is thrown upon deficit non-reserve currency countries. This fact increases the cost of adjustment for those countries, and reduces the efficiency of certain policy measures, especially when the world economy is not growing at a rapid pace.

The availability and stability of foreign financing constitute the third international factor which urgently requires policy action. As mentioned in section III, banks' lending to LDCs and especially to Latin America grew at extraordinarily high rates during the

seventies. In hindsight, although investment rates, GNP, and export growth rates were high in some countries, development strategies based on foreign savings had very weak foundations. Excessive reliance on short-term loans created a serious imbalance between the maturity structure of investment and the debt, increasing countries' vulnerability to debt servicing problems. Foreign finance in some cases substituted domestic savings, stimulating consumption. The overabundance of foreign exchange contributed to overvalued exchange rates, putting a brake on export dynamism. Also, attempts to maintain activity levels in the face of the oil shocks, and the stimulation of speculative private capital outflows (by high U.S. interest rates and the expectations of domestic exchange rate depreciations) were other factors that contributed to offset bank lending partially and to hamper its efficient use.

Private banks' initial reaction to debt servicing problems in the eighties was not only to try to reduce their exposure with LDCs, which by mid-1983 was over US \$330 billion, but also to charge additional commissions and fees in the rescheduling schemes (which only very recently have tended to diminish slightly), which have added an extra cost to already high interest rates. It is evident that, because of their aggressive loan policies and their less-than-adequate project and risk evaluations, banks bear a share of responsibility in the development of the current balance-of-payments crises. The banks tend to argue that, because of a very competitive supply side of the market, spreads were low in the seventies, and insufficient provisions were made to cope with a generalized payments crisis. However, their current behavior, suddenly attempting to block access of "problem" countries to financial markets and setting up rescheduling procedures that have increased financial costs substantially, is helping to augment external imbalances, throwing practically all the burden of adjustment costs on debtor countries.

At the same time that financial costs have risen, bank lending has declined, and there is little reason to expect it to increase in the near future, except under forceful IMF pressure. However, as real interest rates will probably diminish slightly and slowly, if at all, even huge and costly balance-of-trade surpluses in debtor countries may not be sufficient to close the foreign exchange gap, and countries will require additional loans. The only possible sources would be advanced-country governments, which find themselves under

severe budget constraints, and multilateral institutions, which even if they increased their capital and lending capacity to what seem reasonable limits, would still fall short of required needs. Therefore, although the direct and indirect roles of the IBRD and IMF in international financing should be strengthened, it appears that no solution to the LDCs' debt problem will be viable unless it includes a reduction of the real burden of debt.

A final element in the international scenario — one which has not been sufficiently incorporated in current approaches to adjustment policies — is the extent of interrelation among countries and regions, through both trade and finance. As the world has become more interdependent, actions by one group of countries are bound to affect the rest. Actions in the same direction by most or by all countries will produce in any individual country an effect substantially different from the one that might have been expected from that country's policies alone. The growing interdependence is reflected in the fact that if a country takes adjustment measures to reduce a deficit, while surplus countries are applying expansionary policies, the result will be a faster and smoother adjustment process at substantially reduced economic and social costs. However, that is not what is happening now. A reduction in expenditures in a deficit country, designed to free additional resources for use in the tradeable goods sector, will be defeated in its purpose if the rest of the world is also compressing domestic demand because of, say, anti-inflationary policies. The case of import protection is even more clear: policies to promote export in deficit countries will be defeated if the rest of the world prevents those exports from finding markets. Similarly, if one country devalues its currency to produce a reduction in the external sector gap, it may achieve its purpose; but if many countries producing similar commodities devalue at the same time, the result will not be adjustment, but a reduction in the prices of exports of those countries and a worsening in their terms of trade which might even increase the imbalance.

An excessive reliance on adjustment is delaying the North's recovery, since LDC markets for industrialized country exports are not marginal anymore. Added to the "fallacy of composition" implicit in regional export promotion within a stagnant world economy, is the fact that import cutbacks in LDCs feed the recessionary tendencies in the rest of the world and delay economic recovery in those same countries. According to Professor Koren,

President of the Austrian National Bank, about 20 per cent of world trade is affected by difficulties in deficit countries. Thus it has become problematic to impose economic policy conditions on many countries simultaneously while at the same time expecting them to raise their exports and lower their imports. If many countries were to meet those conditions at one and the same time, the system could not function (BIS press review, October 27, 1983).

In 1983 through August, the United Kingdom's exports to Latin America fell by 35 per cent relative to the same period in 1982, and some calculations indicate that the fall in the United States' merchandise exports to Latin America accounted for over 40 per cent of the total decline in U.S. exports in 1982 and was responsible for the loss of 250,000 jobs in the United States, generally in areas where unemployment was higher than the United States' average (see S. Dhar "United States Trade with Latin America: Consequences of Financing Constraints," Federal Reserve Bank of New York, Quarterly Review, Autumn 1983, Vol. 8, No. 3).

On the financial side, it has been estimated that the debt exposure of the major private banks in LDCs amounts to more than twice their capital and that the annual interest owed to such banks by LDCs is more than the banks' total profits (see R. Wienert, "Banks and Bankruptcy," *Foreign Policy*, No 50, Spring 1983).

Consequently, present approaches to adjustment that throw the burden basically on deficit countries and that are strongly biased toward recessionary policies should be complemented by trade liberalization policies in advanced countries and by a major, new role of financing, through better debt rescheduling and higher net capital inflows to LDCs. This is in the interest of both North and South, not only because it would stimulate higher global output and trade growth, but also because it would minimize the prospects of partial or generalized default and thus of an even deeper and more prolonged world depression.

### *Adjustment Policies at the Country Level*

Current adjustment policies in LDCs have been inspired by the traditional IMF approach implemented in the fifties and sixties to improve debtor countries' trade balance. Section III showed that an extraordinary effort by most Latin American countries has been

made, with huge economic and social costs. Although trade balance improvement has been impressive, it has not been sufficient to generate the resources required to fill the foreign exchange gap. That is why most countries have had to reschedule foreign debt and still need higher capital inflows and/or a reduction in the real value of debt service in order to finance interest payments.

The adjustment experience during the eighties has revived the discussion regarding the efficacy of adjustment and regarding burden sharing among debtor and creditor countries. The Latin American case reveals that certain old criticisms of traditional policies have a solid basis and should receive more attention from multilateral organizations and advanced countries. But also, changes on the international, regional and local scenes in the seventies and eighties have brought up new, non-traditional issues and problems, which should also be incorporated in the analysis and discussion concerning policies for more efficient and equitable adjustment processes.

Adjustment policies recently implemented in Latin America show a clear recessionary bias. Improvement in the trade balance has been achieved essentially through lowering imports and diminishing the countries' standards of living rather than by increasing exports. In other words, the reduction in aggregate demand tends to outweigh the change in output composition, while supply-oriented policies have proven particularly ineffective. The world recession and increasing protectionism have contributed to this situation as has the fact that outward-looking policies, when implemented globally, are less efficient than (what is implicit in current policy prescriptions) when applied by a single "small" country.

However, it seems that the traditional approach, applied rather homogeneously to a number of quite different country cases, which assumes that current account problems are derived from excess demand for goods, blurs the basic fact that financial service payments are the major component of the current account deficit. Therefore, given that the debt was acquired through time and that interest rates are now extremely high, policy prescriptions aimed at reducing "excess spending behavior," and attempting to solve a "stock" problem with traditional instruments based on generating an excess flow of goods, focus attention on issues and variables that, although related to the problem, are perhaps not the most essential.

Furthermore, as mentioned in section II, when restrictive fiscal and monetary policies are implemented and devaluation takes place,

the export and import-substitution sectors tend to respond slowly, while imports and economic growth slow down rather quickly, and the supply of non-tradeables tends to stagnate, if not fall, facing a scale effect that in the short run is much more important than the relative price effect. From a developmental perspective, traditional adjustment measures present the further problem that the recessionary impact tends to fall heavily on investment, since people will attempt to maintain existing levels of consumption. Finally, inflation associated to devaluation, together with a decrease in real wages and increases in unemployment, generates a regressive domestic distribution of the burden of adjustment.

The above-mentioned factors, traditionally associated to "orthodox" adjustment policies, have been amplified not only by the international environment of the eighties — mainly the world recession, terms of trade deterioration and higher interest rates — but also by inconsistencies associated with new phenomena that tend to exacerbate economic fluctuations and recessionary effects. The amount of adjustment required has been amplified by the fact that trade balance has had to improve not only to account for higher debt service payments but also to compensate for the smaller net lendings due to the procyclical behavior of the commercial banks. This "overadjustment" tends to be self-defeating, since, as relative price-changes prove less effective in reducing deficits, forcing additional emphasis on restrictive measures, these excessive restrictions damage the economic system as a whole and tend to increase the risks of lending as seen by the creditors.

In a number of countries, a situation similar to what has happened internationally in terms of debt service capacity has occurred domestically. Much of the debt problem has its origins not only in the lack of foreign exchange but also in the fact that domestic residents — firms and persons — have been unable to service their domestic debt. This situation, related to inefficient resource allocation in previous years, has been exacerbated by the microeconomic effects of the adjustment policies that are being implemented. Falling sales and increasing taxes and financial costs squeeze firms' profits as well as consumers' ability to pay, shaking the soundness of domestic financial systems and increasing the costs of the adjustment process as a whole. The need for recovery of the economy, so that domestic illiquidity and/or insolvency is eliminated (a necessary

condition to servicing the foreign debt), is contradicted by the recessionary effect of adjustment policies actually being implemented.

Closely related to the internal debt issue is the fact that in a number of Latin American countries, especially those which engaged in unrestricted liberalization-cum-stabilization programs, domestic real interest rates reached excessively high levels and experienced extremely sharp movements. While those developments might have been justified on the basis of events taking place in the credit markets, their impact on other aspects of the economy should have received a closer look and should have evoked actions to deal with events affecting those rates, so as to achieve better results in overall objectives of economic policy. Similarly, the extraordinary affluence of foreign capital, anti-inflationary policies based on exchange rate management, and the trend integrating the goods markets into the world economy (which lowered barriers to trade) generated grossly overvalued exchange rates in many cases, and thereby stimulated huge private capital outflows from the region in the wake of the world recession. In summary, the behavior of certain variables, namely exchange and interest rates, as well as real wages, foreign debt and asset prices, as "outliers," has enormously complicated and increased the cost of adjustment policies, since much more drastic changes in relative prices are required, which, furthermore, may end up being in contradiction with overall desired results.

The behavior of asset prices merits special consideration. In some Latin American economies in the late seventies, and to a certain extent up to the present, real and financial asset prices soared, without an adequate capital accumulation effort, creating a "bubble effect" which stimulated private expenditure. Being costlier than domestic financing, foreign private sector excess spending could be funded from abroad, avoiding tight domestic credit or money markets. In many cases this was the main domestic cause of the external imbalance. However, the traditional approach to adjustment assumes that the public sector deficit is the principal element behind excess spending, and that higher prices for public sector services, lower government spending, higher taxes, etc., are called for. Obviously, although the trade balance will improve under such measures, distortions will be created in the domestic economy, which, together with an unnecessary fall in investment, will further increase the costs association with current adjustment.

Finally, given the probable long duration of slower growth rates in industrialized countries, higher real interest rates in international markets, and smaller increases in foreign financing available to LDCs, it would seem desirable for the adjustment process in debtor countries to be guided not only by short-run financial or balance-of-payments considerations, but by long-run, developmental objectives. This will require an attempt to minimize and distribute better the adjustment cost in the short run, and it will require appropriate "intervened" — as opposed to automatic — adjustment. In particular, policies aimed at increasing the flexibility of the domestic structure of debtor economies are called for. In this respect, the recent experience in some of the Asian NICs, particularly Taiwan and to a lesser extent Korea — which have relied less on debt, have increased and diversified exports to both advanced and oil-exporting countries, and have substituted rather than reduced imports — could be quite illuminating.

## **V. Final Comments and Conclusions — A New Proposal**

The economic size of the developing world and its linkages both through trade and finance to industrialized countries indicate the need to give higher priority to a global approach to the balance-of-payments problems of LDCs. Even though adjustment is required, the prevailing approach considers countries on a case-by-case basis and tends to minimize the effects of the world economic stagnation on LDC recovery and that of their adjustment on advanced countries' exports and activity levels. Also, the characteristics of the world economy today are quite different from those prevailing in the fifties and sixties. They require from the international community, and especially from the IMF, a new approach to old problems. Recent experience shows, however, that apart from the IMF role in leading efforts to obtain additional financing, no major effort is being made in that direction. Implementation of traditional ideas and standard policies in the new international scenario are increasing the burden on LDCs of problems which urgently require a more efficient and equitable solution than the one currently being pursued. These considerations, together with the fact that developments outside of LDCs' policies and responsibilities have played a major role in the actual crisis, point to a need for more financing than has been available during the renegotiation processes

since August 1982.

The adjustment and "overadjustment" of most debtor countries in the past eighteen months have been impressive. In spite of the huge economic and social costs incurred, in terms of losses in output and higher inflation and unemployment, trade surpluses have not been sufficient to compensate for interest payments and smaller inflows of capital. The monetary authorities and governments in industrialized countries, together with the IMF and private banks, have helped by rescheduling and consolidating existing debt.

These results, and the magnitude of the problems yet to be solved, show that the current approach to adjustment has so far succeeded mainly in buying time, at high and not equitably shared costs. It is doubtful, however, whether the present arrangements have bought enough time for all the countries concerned or whether they can be used to buy much more in the future.

Private bankers, especially smaller ones, are displeased with what they perceive as "arm-twisting" and increasing official interference in their business, although many of them would appreciate being bailed out by their monetary authorities. The IMF's credibility has been shaken by the many breakdowns in its programs. Industrialized countries' concern about eventual tax increases and trade competition from abroad is reducing their governments' policy options. Last but not least, although it is true that "there is no such thing as a painless adjustment," the question is whether, over the longer term, current adjustment policies in debtor countries — which tend to maximize costs in terms of output and employment losses and lower investment — will be worth the economic and social costs incurred. Many of the developing countries are concluding that adjustment cannot go on for much longer and are pressing for a more equitable and development-oriented solution to current problems. Furthermore, they correctly argue that over the longer-term, improved creditworthiness must be based on growth in output and exports and not on reduction of economic activity.

As already mentioned, economic recovery as well as lower protectionism and interest rates in industrialized countries would clearly help. However, it seems that even if developments in the world economy go in the right direction, neither their speed nor their foreseeable tendency values will be sufficient to induce urgently needed growth in debtor countries. Furthermore, as most of these countries begin with such high debt burdens, they probably cannot

return to normal market borrowing for some years to come. Therefore, together with a healthier international economy, there is need for new loans and adequate growth of official development assistance so as to allow domestic policy changes to be accomplished more smoothly.

As lending banks view their exposure with debtor countries as too high by today's standards, and given that the external financial constraint on LDCs is the most pressing one, no solution in the near future seems feasible without a fall in the real debt burden. In this context, a number of proposals have been advanced, which include special treatment in both amortization and interest payments. (Most of these proposals are contained in M. Guerguil, "La crisis financiera internacional: diagnosticos y prescripciones," ECLA, mimeo, November 1983.) They range from outright purchases of the loans by governments or official institutions, to the establishment of long grace periods and guarantee schemes which would allow both lenders and borrowers time to alleviate their problems, to the most extreme notions of exchanging real assets for debt.

The major problem regarding the adoption of most of these schemes is the political implications involved in the capital losses associated with them. Although most of the debt problem is one of temporary illiquidity and not of fundamental insolvency, and in spite of recent and current emergency actions, many LDCs will not be able to service their debt, and, therefore, its level must be reduced. Someone has to take the losses. In industrialized countries the possibilities are reduced to savers or depositors, tax payers, or the banks' shareholders.

Banks will have to keep lending to debtor countries, because otherwise they will not even receive interest, or they might have to lower interest rates and/or commissions and fees in future (unavoidable) reschedulings, reducing their earnings. A certain amount of money is likely to be lost, and one possibility is that it will have to be written off by the creditor and spread over time, so as to preserve confidence in the banking system. On the other hand, some proposals suggest that it is LDCs which should take the capital loss, in addition to current losses in output and employment, by exchanging part of the outstanding debt for shares in firms that their governments control (Metzler, *Financial Times*, 14 December 1983). A whole menu of intermediate proposals have been suggested, including

a major role for SDRs (Avramovic, "The Debt Problem of Developing Countries at End 1982," *Aussenwirtschaft*, March 1983); reconversion of currencies as loans are rescheduled (Zombanakis, *Financial Times*, 9 November 1983); and stabilizing the real value of debt in terms of dollars (Brittan, "World Debt: A Suggestion," *Financial Times*, 29 September 1983).

In the atmosphere of emergency which has prevailed until recently, when the restoration of confidence in the banking system and avoiding defaults by Third World countries had overwhelming importance, some of these ideas could not be considered seriously. But now is the time for all parties concerned (in particular, governments, monetary authorities and commercial banks in industrialized countries, all of which share the responsibility and ought to share the debt burden) to study these proposals and act appropriately.

As indicated above, the facts that interest rates are substantially higher than their long-term average, and that they apply to the bulk of the external debt of LDCs, compound the difficulty of debt service payment. In the case of Latin America, amortization and interest payments of medium and long-term debt absorb more than 50 per cent of exports of goods and services, and more than 60 per cent for five countries of the region, after renegotiation. A one percentage point change in external interest rates represents US \$2.8 billion per year, a sum equivalent to roughly 3 per cent of total exports of the region.

Lenders are normally willing to reprogram or refinance amortization payments, but there are very few cases where this extends to interest payments. A reduction in interest payments below market rates would reduce the operational income of the lending institutions without a corresponding reduction in operating costs. Interest rates are not under the control of borrowers or lenders. They are a result of macroeconomic policies, and, since these policies are not stable, interest rates cannot be expected to stabilize in the short run. Furthermore, the level of such rates in real terms is now five or six times higher than the longer-term (10 or 20-year) averages. But if interest rates cannot be stabilized at normal levels, interest payments can be. A new proposal is as follows (C. Massad, November 1983):

- a) A "reference" rate in real terms is established at a level slightly higher than long-term averages plus normal spreads.

- b) Original debtors pay interest in their own currencies to their central banks, at market rates.
- c) The central bank pays interest to creditors up to a maximum equal to the reference rate. The difference, if positive, is accumulated in special accounts at the central bank of the debtor country, credited to the original creditors.
- d) If negative, the difference would be paid to the creditors by the central bank, drawing against the funds accumulated in the special accounts, insofar as there remain resources accumulated in the accounts. Such resources would accumulate when the market rates exceed the reference rate and would disperse in the opposite case.
- e) The central bank would assume the exchange risk, but not the commercial risk.
- f) Creditors could present the amounts accumulated in the special accounts of the central bank in their own accounting as a credit guaranteed by the central bank involved.
- g) The system would operate as long as there are resources accumulated in the special accounts.

The proposal could make a very substantive contribution to strengthening the portfolio of creditor banks and to normalizing the situation in the financial markets. Of course, the liquidity problem involved for creditors (banks pay interest at the going rate, but would get it only through time) could be taken care of with the support of their own monetary authority. It would be a minimum contribution to the solution of a problem in which all parties involved bear some responsibility.

Two aspects of the proposal require global agreements: one is the necessary support of creditor institutions by the national monetary authorities of creditor countries; the other is the general characteristics of the system and the general conditions for its application. The IMF could lead the effort to achieve such agreements. The proposal does not require setting up new institutions nor asset transfers among creditors or between them and international organizations. The proposal also provides a simple mechanism for interest subsidization, if desired: funds put at the disposal of central banks could be used to reduce the amounts accumulated in the special account.

Other aspects, such as the precise scope of the system, rates and spreads involved, funds accumulated in the special account and not fully drawn before payment of the debt, etc., are matters of negotiation, but it will be easy to propose some options when needed. Finally, the scheme could run parallel to the rescheduling of debt amortization payments and need not interfere with it.

It is very probable that after the emergency, debtor countries will still find serious constraints limiting the scope for expansionary policies and complicating the achievement of growth rates similar to those observed in the seventies. The most important constraint will be external financing. In general, it will not be easy for governments or central banks of advanced countries or for official multilateral institutions to compensate for the expected smaller rate of increase in private bank lending. Improved financial management by LDCs, such as diversifying currency composition of debt and using new financial tools and techniques, will be needed to optimize the use of limited available foreign finance. In addition to this, it seems that the smaller importance of financial credits will have to be compensated by resource transfers from industrialized countries in other forms, mainly direct foreign investment, whose share in the seventies diminished abruptly in favor of bank credits. New thinking is needed in this area also, so as to avoid the mistakes of the past.

On the internal front, adjustment and policy measures in debtor countries should be designed and implemented with a longer time horizon than at present. Greater reliance on domestic saving, and efficient resource allocation addressed at increasing employment and the rate of growth of output and exports, are required. Recent experience in Latin America and some countries in Southeast Asia suggests that much more attention should now be given than in the past to "macroprice management" — i.e., exchange rate, interest rate and wage policies. Consistent policies in these areas may contribute decisively to increase saving and allocate investment more efficiently. This, together with adequate pricing policies and reforms aiming at increasing market and management flexibility, in a joint effort by the government and the private sector, should help to put those countries on a higher growth path, based on a dynamic tradeables sector which can be induced to use labor-intensive technologies.

1/ Naturally, as a result of alternative hypotheses developed to explain these disequilibria and imbalances, different "structural" changes have been proposed: the nature and speed of reindustrialization, supply side economics, redefinition of government intervention in the economic sphere, implications of the size and characteristics of the "welfare state" on overall economic performance, etc.

2/ It is implicitly assumed that authorities sterilize the monetary effects of the net increase in foreign debt; otherwise, the fall in money supply generated by the net inflow of foreign exchange would induce a sort of endogenous adjustment process through its depressing effects on aggregate demand and expenditure.

# **PART III**

## **ADJUSTMENT EXPERIENCES**

“No country in the world can accept passively a condemnation to stagnation, particularly where growth is needed to open up the channels of social mobility.”

— Carlos G. Langoni



## CHAPTER 6

### *An Overview\**

Richard Fletcher

Sooner or later, a country that finds itself in a situation of persistent economic disequilibrium must take steps to adjust, that is, to restore its economy to viability. The crisis of the 1980s has forced an unusually large number of LDCs to adjust by taking contractionary measures, thereby creating difficulties not only for themselves but for the entire world.

Between World War II and 1980, there were many occasions when countries got into difficulties which required corrective action. However, the context was one of strong growth in the world economy. Thus most countries were able to avoid severe contraction and to resume growth after relatively short periods.

The crisis of the early 1980s occurs in a very different context, namely, one of widespread recession. In this situation, individual adjustments cannot be considered as purely national problems. To illustrate, if only one country needs to adjust, it can reduce imports. If very many countries need to adjust, they cannot all simultaneously reduce imports. To do so would simply make everyone worse off without correcting the underlying disequilibria.

The severity of the current crisis has also raised the problem of the size of the adjustment which countries must undertake. Small adjustments can be managed relatively easily, since they involve marginal changes, which do not disturb a nation's basic socio-economic structure. Large adjustment, however, require fundamental restructuring of economic relationships. This may involve substantial and perhaps violent changes in a political system. In any event, fundamental changes take a long time, particularly where a country's economic structure is not well developed.

A review of some of the recent experiences with adjustment yields some useful insights. There is consensus that the East Asian

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*\* Based on the rapporteur's summary, discussion and presentations in the workshop on adjustment experiences.*

countries (e.g., Taiwan and South Korea) did better than most other LDCs in adapting to the "shocks" of the mid and late 1970s. Chapter 9 argues that these nations do not owe their relative success to any special treatment by the developed world. Rather, it results from a solid industrial foundation laid in the 1950s and '60s, in the form of labor-intensive export industries. In addition, these countries made rapid policy corrections in both the public and private sectors after the shocks in the 1970s. In short, the East Asian success is due to the speed with which these countries adopted appropriate policies of export promotion and prudent macroeconomic management.

The East Asian success story, though the best known, is not unique. Chapter 8 shows that South Asian countries (e.g., Pakistan) have also done remarkably well. On the other hand, adjustment in sub-Saharan Africa has generally had tragic results in terms of sharp increases in poverty levels. The African experience illustrates how difficult it is for a country to make a rapid and successful adjustment when its industrial base is limited and skills are scarce. In such a case, export promotion has no chance of working in the short run.

The experiences of the countries of the Southern Cone of South America — Argentina, Chile and Uruguay — are also instructive. As Chapter 7 points out, these countries began an adjustment process in the late 1970s which gave priority to reducing inflation. Adjustment policies were based on the monetarist approach to economic management and stressed reduction in the role of government, together with financial and commercial opening to the outside world. Initial results in these countries were very encouraging: they all experienced reductions in the rate of inflation, with increased imports financed by large inflows of external capital. Unfortunately, the capital inflows encouraged overvaluation of exchange rates and a loss of competitiveness of local industry. Then the onset of the world liquidity crisis in the early 1980s led to a dramatic reversal of capital flows and substantial declines in production.

Assessment of the reasons for success or failure in the variety of experiences leads to a number of conclusions about efficient adjustment:

The *first* lesson is that prevention is better than cure. The LDCs should construct a diversified base of labor-intensive export industry capable of competing in different products and geographical markets.

In other words the LDCs should hedge, if possible, rather than concentrate on a particular product or market as the preponderant source of foreign exchange earnings.

*Second*, if external shocks or inappropriate internal policies lead a country's economy into disequilibrium, corrective action should be taken quickly. External finance should be used to facilitate adjustment rather than as a means of postponing it.

*Third*, in the present context of global recession, adjustment of individual countries should be directed at export expansion rather than at reduction of aggregate demand. The combined effect of numerous policies of demand reduction would be to worsen the current crisis.

*Fourth*, where countries have very underdeveloped industry, adjustment will take time and will require extraordinary levels of concessional assistance. Since the total needs of these countries (e.g., in sub-Saharan Africa) are small relative to the global economy, the IMF should allow them wider limits of borrowing against quotas.

*Finally*, there is the very grim prospect raised in Chapter 9 that the present crisis may not be of short duration but could be the start of a long-term unfavorable trend. If so, this could have serious political as well as economic consequences. Since World War II, many LDCs have evolved an implicit social contract that emphasizes economic growth and development. This "growth imperative" is built into the ethos of each society and into the expectations of all social classes. If the present international monetary system is unable to make the reforms necessary to restore a favorable trend of growth in world trade and output, then the LDCs will have to face the task of forging a new social contract, one which is capable of coping not only with shocks but also with the more frightening prospect of long-term stagnation.

## CHAPTER 7

### *Stabilization and Adjustment in the Southern Cone of Latin America\**

Joseph Ramos

#### A. Introduction

Two economic problems contributed to the political upheavals which gave rise to neoconservative experiences in Argentina, Chile and Uruguay: galloping inflation and disequilibria in their external accounts. To be sure, these three Southern Cone countries had long tolerated inflation. Indexing was widespread, and most economic agents had long come to think in real, and not nominal terms. Yet the efficacy of such instruments was eroded seriously when triple digit inflation beset them. The costs of 600 per cent inflation in Chile (1973), 300 per cent in Argentina (1975), and close to 100 per cent in Uruguay (1973) and the fear of hyperinflation made each of them, especially the first two, assign top priority to an anti inflationary stabilization policy from the very beginning.

These countries were beset not only with unprecedented rates of inflation, but with serious disequilibria in external accounts as well: the deficit in current account at the onset of the new regimes ranged from 20 per cent of the value of exports (Chile) and 27 per cent (Uruguay) to 37 per cent (Argentina); and their debt/export ratios were among the highest of Latin America at the same time: 1.7 in Uruguay, 1.9 in Argentina, and 2.5 in Chile. Thus they had to tackle two major sources of disequilibrium right from the start.

The purpose of this paper is to analyze the stabilization and adjustment policies pursued by each of these countries; to establish at what cost, in terms of output and income distribution, these disequilibria were corrected; and to determine to what extent the

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\* *This is a chapter of a book entitled *Stabilization and Economic Liberalization in the Southern Cone* (ECLA, 1984 forthcoming). Hence, the emphasis is more on anti-inflationary stabilization than on adjustment.*

costs were avoidable, and what specific policies were responsible for any unnecessary costs. It goes without saying that no policy is ever purely a stabilization or purely an adjustment policy. The problems of internal and external disequilibrium often come together, as they did at the onset of these neoconservative experiences. Nevertheless, it is probably fair to say that in the first years, and especially in Argentina and Chile, the aim was stabilization, subject to a balance of-payments constraint; whereas in the last years (1981 on) the aim was adjustment, subject to an anti-inflationary constraint. Hence the analysis will stress the stabilization features of the first years and the adjustment process of recent years.

**B. The Monetarist Approach to Stabilization:  
Inflation as a Monetary Phenomenon**

The debate concerning the causes of inflation in the Southern Cone have traditionally centered around two schools of thought: the monetarist and the structuralist.<sup>1</sup> Monetarism attributed inflation to an overexpansion of the money supply, normally the result of fiscal deficits. The solution was to correct such maladjustments and slow down the expansion of credit. Structuralists, on the other hand, while not challenging the general relationship between fiscal deficits, monetary expansion and inflation, affirmed that such an expansion was endogenous. That is to say, the monetary authorities often found themselves forced to increase the money supply in order to minimize the impact on output of external disequilibria or of unexpected shortfalls in agricultural output. For example, the (allegedly) low price elasticity of exports and of agricultural output made these economies extremely vulnerable to disequilibria originating in these sectors. Hence, the attempt to overcome the negative consequences of such bottlenecks generated pressure to expand credit. The implication of such an approach was that any attempt to eliminate inflation without overcoming structural bottlenecks in the economy either would have passing success or would lead to recession.

While it is true, as monetarists argued, that in the Southern Cone there has been a very close relation in the long-run between the rate of inflation and the growth of the money supply, in the short run this has not been the case (see table 1). The fact that this rela-

tionship has not held in the short-run paved the way for the structuralists' argument that in order to stop inflation it would not be enough to reduce fiscal deficits and slow down the growth of money supply. Because the velocity of money could fluctuate in a compensatory fashion, and because of the existing rigidities and bottlenecks in the economy, the declaration in the rate of growth of aggregate demand ( $Mv$ ) could slow either the rate of inflation (the desired objective) and/or production (not desired).<sup>2</sup>

Possibly because of the greater simplicity of the monetarist model, possibly because of the insufficient operationality of the structuralist approach, the stabilization policies followed during the fifties and early sixties tended to be monetarist in orientation. On the other hand, because such stabilization programs almost invariably resulted in recession, such an approach slowly fell into disgrace.

Nevertheless, the monetary approach reappeared in the seventies. For one thing, the approach had been enriched theoretically. It was now recognized that velocity (that is to say, the reciprocal of the demand for money) varied; however, it was argued that it varied not in an unpredictable fashion, or in a fashion which automatically compensated monetary growth, but rather that such variation in velocity was stable or at least predictable. On the other hand, while it was not at all clear in what way a deceleration in nominal aggregate demand would divide itself between a slower rate of inflation and/or a recession in the short-run,<sup>3</sup> it was argued that a recession could be avoided to the extent that inflation was correctly anticipated. Secondly, given the urgency of combatting triple digit inflation, it seemed quite unconvincing to attribute a significant causal role to structural factors, or to insist that they must be eliminated in order to avoid higher inflation.

Given the neoconservatives' preference for the market and aversion to administrative controls, it is not at all surprising that these countries initially have adopted a monetarist approach, and more specifically the monetarist approach for a closed economy. With the passing of time, and with the increased opening of the economy, the approach was modified slowly, and the key instrument was no longer the control of the money supply, but exchange policy. In any case, throughout the entire experience, the prevailing intention was to minimize administrative intervention in the market.

## C. Phase-I – Monetarism for a Closed Economy

### 1. *The Logic of the Approach*

The quantitative identity, in its dynamic form, offers a good starting point to explain the stabilization policy of phase I in the three neoconservative experiences of the Southern Cone:  $\dot{M}/M + \dot{v}/v - \dot{P}/P + \dot{Q}/Q$ . If one wants to slow an inflation, one needs to slow down the growth in nominal aggregate demand ( $Mv$ ). Nevertheless, the relative impact which such a deceleration in nominal aggregate demand will have, be it on prices or be it on production, will very much depend on inflationary expectations.<sup>4</sup> If such expectations are fairly uniform among different economic agents and these coincide with the inflationary goal implicit in monetary policy, the deceleration in nominal aggregate demand will fall exclusively on prices (precisely what is desired). But if there is a significant difference between the inflation expected and that consistent with monetary and fiscal policy, the deceleration in nominal aggregate demand will also fall on production (precisely what we want to avoid). In short, however high inflation might be, it is theoretically possible to bring it down without a fall in output.<sup>5</sup> Problems emerge if there are rigidities, especially concerning expectations, for these will slow the adjustment to the new conditions which economic policy is trying to establish.

In other words, if inflation is really nothing other than "too much money chasing too few goods," it is not at all clear why in order to bring down inflation it should be necessary to produce fewer goods. To be sure, stabilization policies often end in recession, but this is not because it is inevitable; rather, it is a sign of failure, a failure to harmonize the expectations of economic agents with the inflationary goal implicit in the fiscal and monetary policies which the government is carrying out.

In the three Southern Cone experiences, serious efforts were made to avoid the formation of "erroneous" inflationary expectations. During the first phase, efforts centered in the labor market, for should inflationary expectations based on past inflation become incorporated into labor contracts, the movement of wages would become terribly rigid. For example, should both entrepreneurs and workers expect inflation to be higher than the rate aimed at by the

government, labor costs would rise, with negative consequences for employment and output. In short, should the government fail to harmonize the inflation in wage contracts with that implicit in economic policy, it would inevitably be confronted with the following dilemma: either ratify such erroneous expectations, easing up its monetary and fiscal policy at the cost of sacrificing its stabilization program, or else persist in its stabilization goals and consonant restrictive economic policy, but at the expense of recession.

We may call this the neoclassical variant of recession (as opposed to the neo-Keynesian one), inasmuch as unemployment and recession would be due to a rise in real labor costs. In other words, unemployment would be a reflection of a disequilibrium in the labor market and not, as in neo-Keynesian models, of a disequilibrium in the goods market. Thus, for neoconservatives, any stabilization program which wishes to avoid recession and unemployment must necessarily attempt to harmonize wage readjustments with the inflationary goal set by the government. This means wage controls. The market left to itself cannot adjust wages to coming inflation, since it cannot know in advance how seriously the government intends to apply its stabilization program. Any such doubts would inevitably create rigidities in expectations and consequently lead to recession.

For reasons of this sort (among others), neoconservatism in the Southern Cone justified the use of administrative controls on wages.<sup>6</sup> However, doubts as to the ability of the market to adjust rapidly in transition situations did not lead to the adoption of similar interventionist measures in other markets (for example, the goods or financial markets).<sup>7</sup> In the latter markets there was apparently confidence that competition would assure rapid and converging adjustments, so that all possible disequilibria in such markets would be quite transitory.

## *2. The Policies*

Inasmuch as inflation was considered to be fundamentally a monetary phenomenon, the key instrument in reducing it was the control of the money supply. However, in order to avoid or minimize recessive costs, control of the money supply had to be accompanied by wage controls. Moreover, a deceleration in the growth of monetary variables required a reduction in the fiscal deficit, all

the more so given the magnitudes involved at the beginning of the neoconservative experiences (fiscal deficits ranged between 4 and 10 per cent of GNP). This implied an increase in the prices of public services, increased taxes, reductions in current expenditures (principally wages) and, moreover, in Chile, a decline in public investment.

According to the monetary framework, such measures were the *sine qua non* of a price stabilization program. Nevertheless, this program was accompanied by two other measures which would prove to be of paramount importance in the future evolution of these economies. First of all, from the very beginning the three countries faced serious external disequilibria which would require real devaluations (Chile and Uruguay) or the maintenance of a high real exchange rate (Argentina had recently devalued). It is important to note in this context that a recession is not required in order to improve the trade balance. What is required is to reduce domestic spending and switch output towards tradeables (by means of a devaluation and/or an appropriate commercial policy) substituting (not simply reducing) imports and promoting exports.

To the extent to which income declines, one would expect a corresponding decline in real wages. The worsening in the terms of trade which Argentina and Uruguay experienced from the very beginning, and Chile as of the end of 1974, would necessarily require some decline, though modest, in real wages.<sup>8</sup>

Secondly, there existed a widespread system of price controls in the three countries. As a result, relative prices were severely distorted (creating downward pressure on food prices relative to industrial goods and/or repressing inflation).<sup>9</sup> For these reasons price controls were eliminated in all three countries. Such a policy was radical and abrupt in Chile, gradual in Uruguay, and erratic in Argentina.

Thus it is evident that the policies pursued in these three countries were not limited solely nor principally to the fight against inflation; rather, in differing degrees, each country made serious attempts to restore equilibrium in the external sector and to correct the heavily distorted system of relative prices.

### 3. *The Results*

External disequilibria improved significantly during the first phase, and inflation was reduced. although it was reduced at a much

### Table 1

### Southern Cone: Growth of Money, Prices, and Product, 1950-1970

(Annual rates of growth)

	Argentina			Chile			Uruguay		
	M	P	GNP	M	P	GNP	M	P	PIB
1950	23.2	26.0	1.6	16.4	15.1	4.8	22.0	-7.1	3.1
1951	22.7	30.8	3.9	32.1	22.6	5.3	-1.3	15.4	8.2
1952	13.2	41.2	-5.1	37.0	23.1	3.4	9.0	15.6	-0.4
1953	25.7	5.0	5.4	53.0	25.0	7.1	12.9	5.8	6.5
1954	19.7	16.0	4.1	47.0	71.0	0.7	7.3	14.5	5.7
1955	18.0	14.3	7.1	63.0	84.2	2.7	5.8	7.9	1.6
1956	16.6	12.5	2.8	38.0	37.5	0.7	11.9	7.4	1.7
1957	13.0	25.9	5.1	25.0	25.0	2.6	8.4	13.7	1.0
1958	22.8	32.4	6.1	33.3	30.8	4.8	20.4	18.1	-3.6
1959	50.7	100.0	-6.4	37.5	37.4	6.9	35.0	39.8	-2.8
1960	34.9	20.0	7.8	18.1	13.6	5.1	40.8	37.2	3.5
1961	17.9	16.7	7.1	27.8	9.0	6.1	25.3	23.4	2.9
1962	7.1	28.6	-1.6	25.0	12.9	4.6	7.2	10.8	-2.2
1963	20.0	22.2	-2.4	33.9	44.6	5.1	16.0	21.0	0.5
1964	38.9	22.7	10.3	41.1	50.0	4.2	70.7	42.4	2.0
1965	32.0	25.9	9.1	55.2	22.2	5.0	56.0	56.7	1.1
1966	30.3	35.3	0.6	51.4	27.3	7.0	70.1	73.3	3.4
1967	34.9	28.3	2.7	28.4	21.4	2.4	51.1	89.3	-4.1
1968	32.8	15.3	4.3	30.1	23.5	3.0	86.5	125.4	1.6
1969	16.9	8.8	8.6	24.0	28.6	3.5	69.2	21.0	6.1
1970	12.2	12.2	5.4	58.1	33.3	3.6	31.3	16.3	4.7
1950-1970	24.3	23.8	3.7	37.7	30.3	4.2	29.5	29.4	1.8

**Note:** M = money,  $M_1$ ; P = index of consumer prices.

Sources: International Monetary Fund, *International Financial Statistics* May 1976, and *Yearbook* 1980; and ECLA, *Series Historicas del Crecimiento de America Latina*.

Table 2

## Southern Cone: Basic Monetary and Macroeconomic Indicators

	Argentina					Chile					Uruguay				
	Rates of growth				Public surplus GNP	Rates of growth				Public surplus GNP	Rates of growth				Public surplus GNP
	Nominal devaluation	P	M	GNP		Nominal devaluation	P	M	GNP		Nominal devaluation	P	M	GNP	
1973	14.6	61.2	86.3	3.6	-4.4	455.0	441.0	259.1	-5.6	-24.7	55.4	97.0	63.5	0.4	-1.2
1974	-5.3	23.3	93.0	6.2	-5.4	649.5	497.8	314.6	1.0	-10.5	39.0	77.2	80.0	3.1	-3.8
1975	311.2	182.5	90.5	-0.8	-10.3	490.3	379.2	239.2	-12.9	-2.6	89.1	81.4	50.1	5.9	-4.3
1976	282.5	443.2	399.4	-0.5	-7.2	165.8	232.8	216.0	3.5	-2.3	47.7	50.6	67.9	4.0	-2.0
1977	191.1	176.1	176.2	6.4	-2.8	64.9	113.8	156.7	9.9	-1.8	39.9	58.2	45.3	1.2	-1.3
1978	95.2	175.5	142.8	-3.0	-3.2	47.0	50.0	81.2	8.2	-0.8	28.9	44.5	53.0	5.3	-0.9
1979	65.5	159.5	131.4	7.1	-2.7	17.7	33.4	60.0	8.3	1.7	29.3	66.8	99.5	6.2	—
1980	39.5	100.8	115.8	1.1	-3.6	4.7	35.1	62.6	7.8	3.1	15.7	63.5	34.9	5.8	-0.3
1981	139.6	104.5	53.9	-5.9	-11.3	—	19.7	23.4	5.7	1.6	18.7	34.0	33.9	-0.8	-1.5
1982	488.8	164.8	195.7	-5.7	-7.5	30.5	9.9	-5.5	-14.1	-2.4	36.2	19.0	-0.8	-8.7	-14.0
1983p	440.0	320.0	325.0	2.0	—	58.0	30.0	—	-0.5	—	130.0	45.0	—	—	-5.5

Note: P = index of consumer prices; M = money,  $M_1$ ; p = preliminary.

Source: ECLA, on the basis of official sources; International Monetary Fund, *International Financial Statistics*, various numbers.

slower pace than anticipated and at the cost of a sharp fall in real wages (on the order of 25 to 30 per cent with respect to the normal or historical levels) and of severe recession (Chile) or stagnation (Argentina). Growth was possible in Uruguay thanks to the very strong increase in public investment and in exports which more than compensated the decline in domestic consumption.

As far as inflation is concerned, the policies pursued resulted in important reductions in the fiscal deficit and the rate of expansion of the money supply (see table 2). The fiscal deficit fell during the first phase from 9 to 3 per cent of GNP in Argentina (between 1975/76 and 1978); from 25 to 2 per cent in Chile (between 1973 and 1976), and from 4 to 1 per cent in Uruguay (between 1973/74 and 1978). The growth of M1 in the same period decelerated from 250 to 140 per cent a year in Argentina, from 250 to 220 per cent a year in Chile, and from 70 to 55 per cent a year in Uruguay. As a result of restrictive monetary, fiscal and wage policies, inflation fell sharply: from rates on the order of 300 per cent during the last, pre-neoconservative year in Argentina to 175 per cent at the end of phase I, 1978; in Chile from 440 to 230 per cent between 1973 and 1976; and in Uruguay from close to 90 per cent in 1973/74 to 45 per cent in 1978.

As might have been expected, there was a very significant correlation between the fiscal deficit, monetary expansion and the rate of inflation (see graph 1): high rates of inflation were accompanied by large fiscal deficits and very strong monetary growth; whereas low rates of inflation coincided with lower deficits and rather modest monetary expansion. Nonetheless, these relationships were fairly loose in the short-run.

It is reasonable to suppose that in periods of accelerating inflation, the velocity of circulation of money will rise because of inflationary expectations, so that the rate of growth of prices will be greater than that of monetary variables. Nevertheless, during phase I in Argentina and Chile, prices appear to have risen not so much because of the pressure of demand, but because of price decisions taken by the producers themselves in anticipation of a demand for goods which never materialized. For that reason, for example, the increase in prices in the first year (1974) of Chile's neoconservative experiment exceeded the increase in money supply by almost 50 per cent.

Once the inflationary process reversed itself, an inverse relationship would have been expected. That is to say, expectations of a decelerating inflation would increase the demand for money so that prices would grow less rapidly than the growth of money supply. Nevertheless, this did not take place, neither in Argentina nor in Chile. Quite the contrary, in the following years of phase I, though inflation slowed, it continued to advance at a rate well in excess of the growth in money supply (see graph 1 once again). Consequently, during the three years of phase I stabilization, the increase in prices exceeded the expansion of the money supply by over 100 per cent in Chile and by 25 per cent in Argentina.

Moreover, the assumption that inflationary expectations express themselves solely or principally in the labor market is rather doubtful, at least from a theoretical point of view. The policies were also meant to have price effects: to bring about a real devaluation which implied raising the relative price of tradeables, and to raise, by way of a price liberalization, the relative prices of goods heretofore controlled (generally speaking, foodstuffs). Inasmuch as the public could not know how much of the nominal devaluation would be real (corresponding to a relative improvement) and how much would be nominal (a pure inflationary increase), nor how long the policy of price liberalization would last (indeed Argentina restored price controls within the year), it is easy to understand that producers would have set their prices, not in accordance with their current demand or prevailing wage costs, but in accordance with what they expected these to be in the future. They would take into account the expected cost of labor, the expected cost of importing (thus the expected future rate of devaluation), the level of real interest rates,<sup>10</sup> the evolution of public service prices, the evolution of prices heretofore controlled, expectations about other producers' price intentions, etc.<sup>11</sup> Finally, inasmuch as these entrepreneurs faced little competition, especially at the beginning of phase I, they had ample margin to fix prices in accordance with their own inflationary expectations, erroneous or not.

In other words, the need simultaneously to achieve balance in external accounts and to stabilize and correct the distorted price system has made the possibility of achieving reduced inflation without at the same time inducing a recession increasingly difficult. It is not that recession is intrinsically or inevitably a consequence

of the pursuit of either or both of these objectives. Rather, the pursuit of both goals simultaneously with similar sets of instruments, and without consideration of the repercussions these might have on other objectives, jeopardized the success of the stabilization policy. Hence, the deceleration in nominal aggregate demand fell not only on prices, as was desired, but also on the level of economic activity, which obviously was not desired.

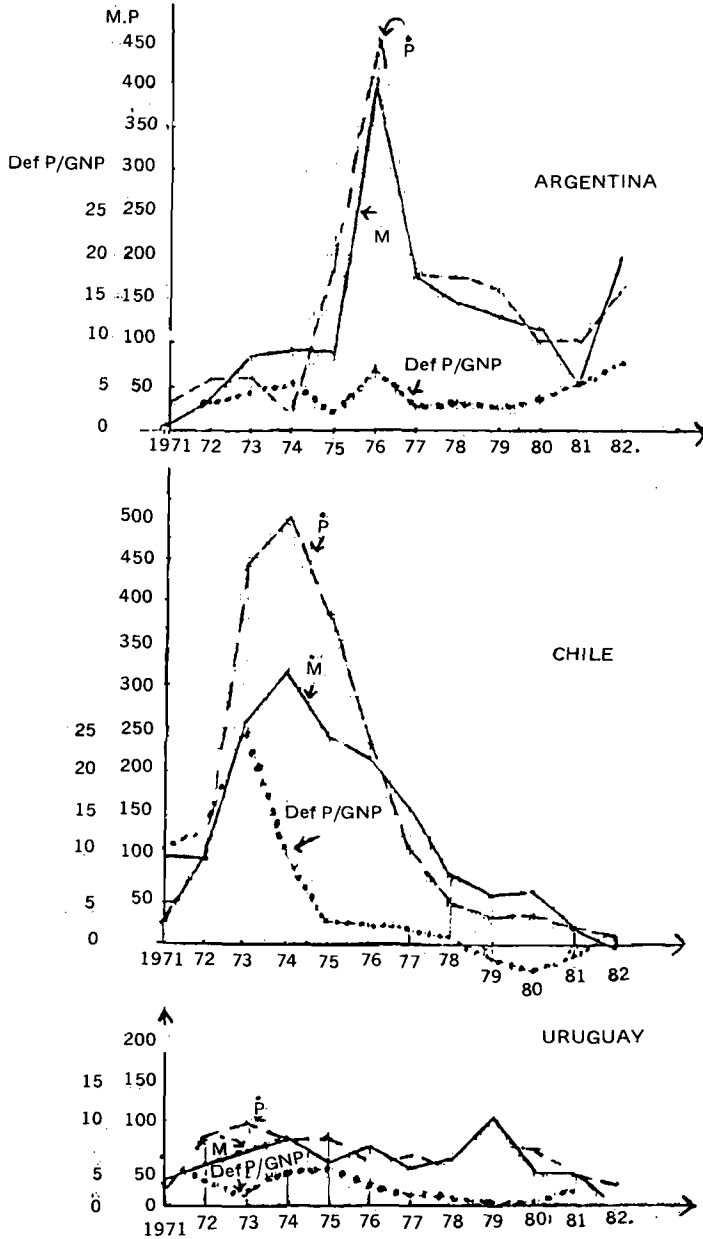
Returning to the stabilization policy in this initial phase, to the extent to which inflationary expectations significantly exceeded the rate of inflation implicit in monetary and fiscal policy, the deceleration in nominal aggregate demand would fall on output (something undesirable) and not only or exclusively on prices. In this case, monetary and fiscal policy would prove to be too tight. And this indeed is exactly what occurred: first, there was too little money for the level of prices which in fact prevailed, that is to say, real interest was too high; secondly, real wages were too low; and thirdly, the level of output and employment was below the productive capacity of the country (that is to say there was recession).<sup>12</sup>

Had the divergence between the inflationary expectations of the public and the rate of inflation implicit in economic policy been closed quickly, the contraction in internal demand would have been harmless. Unfortunately, inflationary expectations adjusted quite slowly, thereby prolonging and worsening the recession. Inflationary expectations adjusted slowly because what producers lost by virtue of lower sales, they made up via higher prices and margins, thus slowing the movement to equilibrium and worsening income distribution (see table 3).<sup>13</sup>

Given that prices remained well above equilibrium, internal demand was insufficient to absorb a fully occupied productive capacity. The economies thus tended to fall into recession. This phenomenon was further aggravated in Chile by a sharp fall in public sector investment and external demand (since the quantum of exports did not grow enough to compensate the very severe decline in its terms of trade). The cumulative effects of reduced consumption (via wage reductions) and investment (cutbacks in public investment and a decline in private investment) and the fall in internal demand resulted in a very sharp economic contraction. GNP per capita in Chile fell 13 per cent between 1973 and 1976. By contrast, the restrictive effects of the stabilization policy were compensated in

Figure 1

Inflation (P), Expansion of Money Supply (M)  
And Fiscal Deficit (Def F/GNP)





Argentina and even more than compensated in Uruguay by very sharp increases in public investment and in the volume of exports. Thus, in Argentina and above all in Uruguay, overall demand was re-oriented from domestic consumption to investment and exports, instead of contracting.

The observed differences in the behavior of employment during the first phase in each of these three countries is largely explained by the very different evolution of their respective output and not by the trajectory of real wages which was quite similar in the three (that is to say, a sharp fall). This is the case because in product market disequilibria, where at the prevailing but inflated level of prices one cannot sell all one wishes, the demand for labor is no longer a function of wage costs so much as of the level of sales. Insofar as sales declined (Chile) or did not grow (Argentina), the demand for labor also fell or failed to grow, for however much real wages had fallen, the opportunity cost of unused machines in factories had fallen even more (it was virtually zero). As a result, the primary effect of the fall in wages was to reduce domestic demand for goods, much more than to induce the increased hiring of labor because of its lower cost. This would explain why in future years the growth of employment in Chile coincided with increases and not declines in real wages.

Inversely, in Uruguay, where GNP grew despite the fall in domestic consumption, employment also expanded. That is to say, the unemployment which was generated in this phase was not so much a symptom of a disequilibrium in the labor market — whose resolution would have required a lowering of real wages — but rather was a result of a disequilibrium in the goods market (overshot prices with depressed sales). The employment problem could not be resolved until the basic disequilibria affecting the goods market were resolved.<sup>14</sup> Hence, notwithstanding the high rate of inflation, unemployment was due to a lack of aggregate demand. The problem thus was not price rigidity so much as the rigidity in inflationary expectations. Consequently, inflation slowed much more slowly than the rate implicit in the monetary, fiscal, and wage policies being pursued by the government.

## **D. Phase-II – The Monetary Approach to the Balance of Payments**

### **1. *Its Logic***

The failure of inflationary expectations to adjust rapidly limited the degree to which money supply could be decelerated without incurring an excessively severe recession, and so led to a new approach to stabilization. Efforts began to focus on exchange policy. Monetary policy would then become passive, the money supply adjusting automatically to movements in the balance-of-payments. The exchange rate would be devalued from then on, according to a pre established program rather than passively in accordance with past inflation. It was thought that in this way, expectations could be adjusted rapidly to the inflationary goal implicit in government policy. Thus the immediate and prime objective of exchange policy became the control of inflation and no longer the maintenance of the exchange rate in real terms for purposes of trade balance equilibrium.

To be sure, it was not considered necessary to lower the real rate of exchange in order to slow inflation. Rather, it was believed, and certainly hoped, that the announcement of this policy change and its implementation would demonstrate clearly to economic agents the seriousness with which the government intended to pursue its anti-inflationary goal, and so bring down inflationary expectations to the rate of devaluation. Since the latter was programmed to decelerate, the rate of inflation could be expected quickly to equalize the rate of devaluation and so, the inflationary goal.<sup>15</sup> Should this occur rapidly, the overshoot level of prices and the ensuing disequilibrium could be corrected without any further costs in output. At the same time, the real rate of exchange would be maintained.

Exchange policy was expected to influence the behavior of prices not only via expectations, but in a more direct fashion. At least as far as tradeables were concerned, it would tend to limit the price of domestic products to that of the imports with which these competed. At this stage, the three economies had substantially opened up imports, so that domestic prices had a ceiling given by the international price of the imported goods plus transport, tariffs, and retailing costs. This ceiling is the so-called "law of one price." Given the relatively free flow of imports, it was believed that, regard-

less of what inflationary expectations were, the price of domestic goods would have to converge to this price. At the same time, the liberalization of the domestic capital market had created substitutes for money which made it increasingly difficult to control the supply of money. Monetary control was further complicated by the financial opening-up to the outside world. Money growth began to be explained largely by exchange operations, and not, as in the past, principally by the expansion of internal credit or treasury financing. These facts were a further argument on behalf of this new exchange policy.

The monetary approach to the balance-of-payments provided the underlying theoretical basis for this policy change. According to this view, differences in the amount of money demanded and supplied are resolved through the balance-of-payments (and not by changes in production). For example, given a certain demand for monetary balances, if the supply of internal credit were to contract, the domestic interest rate would rise. Two adjustment mechanisms would then automatically come into play to resolve this difference. If the capital account were open, capital would come in, increasing international reserves, till the supply of money came to equal the amount of money demanded and the initial monetary restriction ended up determining not the amount of money in hand but only its composition (between internal and external credit). On the other hand, were the capital account to be closed, the increase in domestic interest rates would lower the demand for goods, reducing imports, producing a surplus in the trade balance, and augmenting reserves. At the same time, higher interest rates would eventually lower the price of internal goods, generating a further surplus in trade balance, and increasing reserves. Thus the supply of money would expand to the level being demanded.

Implicit in this approach, be it with open or closed capital accounts, is that disequilibria between supply and demand for money are resolved quickly and directly via prices and/or movements in the balance-of-payments and not via changes in the level of output. Ignoring or minimizing the latter as a possibility is a central assumption which this approach shares with the quantity theory of money, in both its earlier and simple version and its more sophisticated and modern version. And it is this assumption which distinguishes these approaches from most others. To be sure, the speed

with which the so-called "law of one price" operates in order to equalize (i) internal and external rates of interest and (ii) and prices of domestic and imported goods,<sup>16</sup> is critical in determining whether adjustment will take place principally via production or via monetary adjustments. The high degree of international liquidity available in the second half of the seventies made condition (i) very plausible; the increased trade opening which the three countries of the Southern Cone underwent (at least as far as eliminating non tariff barriers is concerned) also made it plausible that condition (ii) be satisfied.

## *2. The Policies*

During this phase the stabilization policy centered on the exchange rate. Domestic inflation was expected to converge to international inflation plus the rate of devaluation. Indeed, the level of domestic prices would need to approximate that of international prices. Unfortunately, early in phase II a gap between domestic and international prices emerged, a gap which persisted even after differences arising from transport, tariff and trade costs were taken into account. As a result, at some point in this new phase domestic inflation would have to be less than international inflation plus devaluation, at least until internal prices equaled external prices. This point, critical though it was, tended to be overlooked by policy makers in the Southern Cone.

In any case, it was expected that inflation would decline rapidly, roughly to the level determined by the rate of devaluation. To be sure, no one thought that exchange rates could be fixed immediately, since, so long as inflation continued to be high and the internal factors contributing to monetary expansion persisted, economic agents would see such a fixing of the exchange rate as an unsustainable policy. For example, if M1 were on the order of 10 per cent of GNP and if a public deficit on the order of 5 per cent of GNP were expected, money growth would necessarily have to be about 50 per cent, and so, a rate of inflation of about that magnitude could be expected. Hence, it would be considered reckless for the government to program a devaluation of much less than 40 per cent a year (this would imply an external inflation of 10 per cent). On the other hand, once the public sector deficit was eliminated, there would be

**Table 3**  
**Southern Cone: Indices of Income Distribution<sup>a/</sup>**  
**(1970 = 100)**

	Argentina		Chile		Uruguay	
	A	B	A	B	A	B
1970	100.0	100.0	100.0	100.0	100.0	100.0
1971	98.3	98.8	116.3	113.0	106.3	106.5
1972	81.1	81.9	108.9	105.7	88.3	89.1
1973	84.1	86.4	84.1 <sup>b/</sup>	82.2 <sup>b/</sup>	84.2	87.0
1974	97.9	94.5	64.9	63.6	86.4	86.9
1975	95.9	95.8	71.8	65.0	—	—
1976	64.4	64.3	71.1	64.2	75.2	73.1
1977	61.4	60.8	73.7	65.7	70.4	69.0
1978	64.2	63.5	77.5	68.7	62.3	61.5
1979	69.2	69.1	81.8	71.6	57.4	57.2
1980	76.9	77.5	86.1	74.1	58.1	57.7
1981	73.2	73.2	92.6	78.5	65.7	64.7
1982	70.4	69.8	99.1	78.5	70.3	69.2

Note: a/ Variations in the index indicate whether the share of labor in gross domestic income has improved (above 100) or worsened (below 100) with respect to the base year.

A = The index is defined as  $\frac{(S_R)(0)}{Y}$ , where  $S_R$  = real wage; 0 = index of the number of employed; Y = gross domestic income (gross national product adjusted by the effect of the variation of the terms of trade).

B = An index defined as above (A), but which deflates by gross national product instead of gross domestic income.

b/ The first 8 months of 1973.

Source: ECLA on the basis of official sources.

no reason (according to this approach) why the exchange rate could not be fixed, so that the rate of domestic inflation very rapidly would come to equal that of the industrialized countries. Indeed, to the extent this approach is correct, there would be no other choice than to fix the exchange rate, once the deficit was eliminated. The objective, then, was to devalue at diminishing rates (in order to affect expectations), according to a pre-announced calendar (generally for 6 months).

This policy was begun, at least partially, in Chile as of mid-1976, and in Argentina and Uruguay towards the end of 1978. Once the fiscal deficit was eliminated in Chile in 1979, the exchange rate was fixed at 39 pesos to the dollar, exactly as this approach would suggest. Notwithstanding the fact that the fiscal deficit was also eliminated in Uruguay (in 1979), the authorities there preferred not to fix the exchange rate, at least not yet, for domestic inflation was still on the order of 60 per cent (well above Chile's 33 per cent and the industrialized countries' 10 per cent at that time).

At the same time, with extensive capital available in the international arena, the three Southern Cone countries increased their financial opening to the outside world, in the hopes of achieving an even more rapid convergence of internal and external rates of interest. Then, too, trade was further opened up (a good deal in Chile, somewhat in Argentina, very little in Uruguay) as a means to stimulate competition and press prices to converge rapidly to external ones.

### *3. The Results (see table 2 again)*

While the phase II stabilization program was in effect, both Chile (in 1981) and Uruguay (in 1982) managed to lower inflation to international rates. This reduction was especially spectacular in the case of Chile, where 5 years before inflation exceeded 200 per cent. Inflation was almost halved in Argentina; nevertheless it never fell below 100 per cent a year.

Argentina's inability to control its public deficit would seem to explain why it did not make further progress in this area. Its deficit was never less than 3 per cent of GNP and in 1981, the year of lowest inflation (100 per cent), its deficit once again began to grow, closing at 4 per cent of GNP.<sup>17</sup> This could not fail to have a negative influence on the credibility of its exchange policy. As Rodríguez has argued, it was very hard to believe that the announced policy of devaluing at a rate of 1 per cent per month between July 1980 and May 1981 could be sustained while the rate of inflation was five times that and the expected public deficit was on the order of 6 or 7 per cent of GNP (a fact which in itself implied or suggested a rate of inflation on the order of 80 per cent).<sup>18</sup>

Although an important component of growth was simply a re-

covery, the growth in output in this period in all three countries was well above that experienced during phase I. Output per capita grew at a rate above 2 per cent per year in 1979 and 1980 in Argentina, as opposed to -0.9 per cent per year in 1976-1978; in Chile it recovered and grew at a rate of 6 per cent per year in the 5 years 1977-1981, as opposed to a fall of over 4 per cent per year between 1974 and 1976; and in Uruguay it grew above 5 per cent per year in 1979 and 1980, versus a 3.6 per cent annual growth in the 4 years 1975-78. In other words, the phase II stabilization policy brought on no recession, at least not in its first years.

Inflation, however, fell much more slowly than the decline in the rate of devaluation, creating a problem which would become increasingly serious in the course of time. Between the beginning and the end of phase II, domestic inflation exceeded international inflation plus the rate of devaluation by a substantial amount, so that internal prices were well above those of imported goods. During phase II, the price of domestic relative to imported goods had risen by about 50 per cent in Argentina (between 1978 and 1980), and by almost 30 per cent in Chile (between 1976 and 1981) and Uruguay (between 1978 and 1981). (See table 4.)

Indeed, the loss of competitiveness was even greater than these facts would suggest. During this period, tariffs were lowered, especially in Chile, which meant that foreign goods entered even more cheaply than before. Moreover, real wages, which are an even better indicator of the evolution of domestic costs, tended to recover during phase II, so that costs would have risen by even more than the lag in exchange rate. Once we adjust for both of these phenomena, the increased relative cost of domestic goods with respect to international goods during phase II exceeds 50 per cent in Uruguay and 100 per cent in Argentina and Chile (see column B, table 4).<sup>19</sup>

That the exchange rate lagged is a fact. The question is, Why did it lag? Why did the exchange rate become increasingly revalued? Why didn't the rate of domestic inflation fall more rapidly or fall at the rate at which the exchange rate was being devalued (that rate plus international inflation)? Why did it exceed it by so large a margin? The following hypotheses are pertinent in this regard:

i) The law of one price pertains directly and exclusively to tradeables and these make up but half of the GNP. It is quite likely that many activities relating to commerce, distribution of imports, the financial system, or construction experienced an excessive

Table 4

Southern Cone: Indices of Real Effective Exchange Rate  
(1980 = 100)

	A			B		
	Argentina	Chile	Uruguay	Argentina	Chile	Uruguay
1970	144.6	133.2	110.5	166.6	80.5	62.9
1971	137.2	122.4	101.7	157.6	54.9	53.4
1972	155.2	128.4	125.7	210.8	54.0	117.1
1973	148.5	142.8	107.5	177.4	99.5	81.5
1974	126.9	124.5	103.6	130.0	164.0	80.4
1975	194.1	133.4	119.3	217.6	224.6	95.9
1976	127.9	116.0	127.1	234.6	181.0	108.4
1977	164.9	112.4	126.1	277.6	166.3	116.2
1978	148.8	130.2	122.9	227.7	129.7	120.5
1979	111.7	116.4	103.9	143.0	124.1	120.5
1980	100.0	100.0	100.0	100.0	100.0	100.0
1981	125.8	89.8	95.8	144.3	76.1	82.4
1982	163.2	105.1	110.8	281.7	85.5	90.8

Note: A = indices deflated by the index of wholesale prices.  
B = indices deflated by an index of wages.  
The lower the index, the cheaper are imports in domestic currency and the more expensive are exports.

Sources: ECLA, on the basis of official sources; methodology explained in ECLA, *Economic Survey of Latin America, 1981*, Statistical Appendix.

demand during this period, which raised the prices of certain non tradeables. Insofar as the producers of tradeables tried to maintain their historic relation to non-tradeables, there may have been upward pressures on the prices of some tradeables.

ii) As far as tradeables are concerned, there seems to have existed an excessive margin of protection; that is to say, some tariffs were partially redundant. Hence, a reduction in a tariff did not, in and of itself, bring about a proportional reduction in domestic prices.

iii) In similar fashion, high transport costs (especially for products with little value added per unit volume) and/or high financial costs (especially imports with low turnover) provided natural protection, so that domestic prices did not converge directly with international prices but rather equaled international prices plus the cost

of transport, plus financial costs and tariffs. Therefore, the price of the domestic good could vary widely within a range of prices, the lower limit of which was given by the price at which the good would be imported from abroad, the upper by the price at which it would be exported.<sup>20</sup>

iv) It is reasonable to expect, especially in the initial stages of trade liberalization, that small-scale importers would set their price not equal to international prices plus tariffs (price equals cost), but rather at the level of domestic prices, and a bit less. In this way, price convergence would take place, but upwards to domestic prices and not downwards to international prices, at least in the initial stages.

v) In a later stage, it seems that many importers introduced differentiated products which heretofore had not existed in the domestic market (for example, whiskey) and which, although they took away part of the domestic market from the local product (for example, the local alcoholic beverage), did not affect its price in any significant fashion. In short, inasmuch as the domestic product was but an imperfect substitute for the imported good, it would be very difficult to avoid the loss of its market simply by lowering its price, for the imported good attracted a goodly number of consumers because of its quality, its variety or indeed its novelty, and not solely because of its price.<sup>21</sup>

vi) At the same time, many goods were imported by producers of the very same domestic goods with which they competed. To the extent to which these producers controlled the domestic market, they controlled the price both of the domestic as well as of the imported product, so that domestic prices would continue to remain above international prices plus transport cost, plus tariffs, so long as there was insufficient competition in importing and distribution. Such competition was achieved fully only in relatively standardized products with high turnover, such as television sets, radios and portable cassettes.

All of these are simply reasons why domestic prices will remain above international prices plus tariffs and transport costs for some time. None of these arguments denies that, given enough time, the convergence of domestic prices with international prices will eventually have to take place. But such an adjustment could be quite slow and costly. It was precisely the slow downward adjustment

in prices and inflation in the Southern Cone which made it increasingly likely that the government would find itself forced to abandon its exchange policy.

Obviously, the loss in competitiveness, which the large exchange rate lag implied, had very serious consequences for the balance-of payments, inasmuch as exports were discouraged and imports encouraged. Nevertheless, the more pernicious effects of the lag in exchange rates were not noted or felt at once. For some time, the deficit in current account due to the lag in exchange rates could be financed through the heavy affluence of external credit. Nevertheless, capital inflows on the order of 5 and 10 per cent of GNP (as in 1980 and 1981) clearly were not sustainable in the long-run. As confidence in the maintenance of the ongoing exchange policy weakened, it was necessary to offer extraordinarily high domestic interest rates (on the order of 3 to 4 per cent real per month) in order to attract foreign capital or to impede capital flight.

#### **E. Phase-III – Forced Adjustment to External Disequilibrium**

##### **1. *Its Logic***

A price stabilization policy is never absolutely necessary; one can live with inflation if one so chooses. However, in the case of external disequilibrium, adjustments must be made whether a country wants to or not. In the particular instance of the Southern Cone countries, it would be fair to say that there was no deliberately chosen policy to adjust to external disequilibrium (except for the first few months of this phase), but rather adjustment was forced on them by events.

The lag in exchange rate, which increasingly left domestic prices above international prices, plus the extraordinarily high real rate of interest, were steadily sapping away internal demand. To this was added an ever more imminent and explosive financial crisis. It was, of course, clear by this time that it was necessary to correct the external disequilibrium. And this was seen as unpleasant, because of the standard means, devaluation. An external disequilibrium such as this requires a real depreciation, which could be achieved in either of two ways: one, by raising prices of international goods (expressed in domestic currency) to that of domestic goods via a nominal devaluation of the exchange rate; or by lowering the price of domestic

goods to that of international goods via a deflation, with exchange policy standing pat.

The two approaches are perfectly equivalent in theory, yet in practice they entail different risks. A devaluation of the exchange rate, even though intended simply to correct a distortion in relative prices, could set off inflationary expectations, resulting in an upward spiral in inflation rather than a once-and-for-all shift in prices. Deflation, on the other hand, runs a very high risk of bringing about a severe recession and not just lowering prices and/or inflation — all the more so when the exchange lag to be corrected is, as it was then, on the order of 30 to 50 per cent. Given the size of this disequilibrium, it was difficult to imagine that the full deceleration in nominal aggregate demand could be absorbed immediately and completely by a sharp deceleration in domestic prices (which was of course the desired outcome). Rather it should have been expected that at least some of the deceleration in nominal aggregate demand would fall on production and lead to a recession, a recession which would be more severe the greater the exchange lag to be corrected and the greater the rigidity in inflationary expectations.<sup>22</sup>

## *2. The Policy*

Nevertheless, policymakers in all three countries preferred to bide their time, maintaining their exchange policy, rather than to devalue. They feared that a devaluation of the exchange rate would lead to an explosive resurgence of inflation. And, after all, lower inflation was one of their principal achievements. Hence, they placed their hopes in what was called "automatic adjustment"; that is to say that the deceleration in monetary growth would rapidly lower inflation to a rate less than equal to the rate of devaluation plus international inflation. It should be noted that this option entailed no action except maintenance of the exchange policy. If the balance-of-payments went into deficit, monetary growth would automatically slow. Whether this would have an impact on output as well as prices was another question. The hope was that the brunt if not the whole of the impact of the decline of deceleration in nominal aggregate demand would fall on inflation, rather than on production, and in this way lead to a real devaluation.



Table 6

**Southern Cone: The Evolution of Net Available Financial Resources  
And its Relative Impact on the Economy**

	Argentina				Chile				Uruguay			
	1980	1981	1982	1983	1980	1981	1982	1983	1980	1981	1982	1983
1. Net Capital Flows (millions of US\$)	2,176	1,519	1,807	1,900	3,345	5,008	1,096	440	811	494	-182	40
2. Interest and other Factor Payments (millions of US\$)	1,607	3,701	4,755	4,800	1,028	1,464	1,921	1,620	100	74	197	320
3. Net Transfer of Financial Resources (NTFR) (3)=(1)-(2) (millions of US\$)	569	-2,182	-2,948	-2,900	2,317	3,544	-825	-1,180	711	420	-379	-280
4. Net Transfer of Financial Resources/X	6%	-20%	-33%	-31%	39%	64%	-16%	-25%	47%	25%	-25%	-22%
5. Variation in the Terms of Trade (T of T) as a % of X	12%	-9%	-11%	-3%	-5%	-14%	-11%	9%	-2%	-6%	-1%	0%
6. Additional Capacity to Import because of improved T of T and NTFR, (6)=(4)+(5)	18%	-29%	-44%	-34%	34%	50%	-27%	-16%	45%	19%	-26%	-22%
7. Rate of Growth of Quantum of Imports	49	-12	-44	-17	13	20	-36	-18	16	-11	-19	-39
8. GNP	1.1	-5.9	-5.7	2.0	7.8	5.7	-14.1	-0.5	5.8	-0.1	-8.7	-5.5

Note: X = the value of exports of goods and services.

Source: ECLA on the basis of official sources.

3. *The Results* (see table 5)

The ensuing deceleration in nominal aggregate demand indeed lowered the rate of inflation in all three countries. Nevertheless, the real devaluation achieved by this means (deflation) was not at all important (a few percentage points per semester), much too slow to correct significantly the large exchange lag accumulated in the course of years. In short, the bulk of the contraction in nominal aggregate demand fell not on prices, as desired, but on output. To be sure, imports were thus sharply and "automatically" curtailed, but at the cost of a severe recession in all three countries.

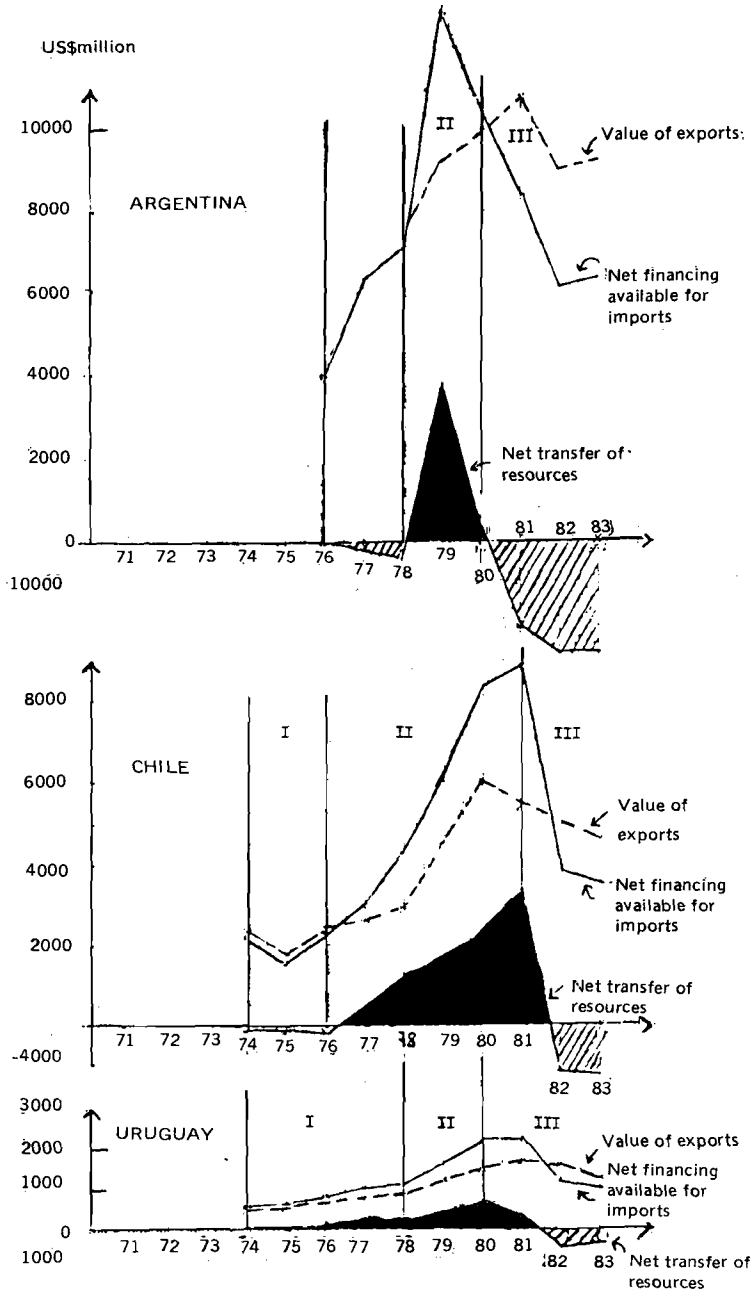
The severity of the recession increased the pressure by domestic producers on governments to abandon the policy of minor (or zero) periodic and pre-announced devaluation and to replace it with a massive devaluation to correct prices quickly. This pressure became irresistible once it became clear that the government could maintain its exchange policy without an even more severe recession only if foreign capital continued to flow in massive proportions. This, of course, was not to be the case. The very decline in internal output, the deceleration in exports and the increasing signs of internal financial crisis eroded the remaining confidence of foreign creditors as to the capacity of these countries to service their foreign debt. The die was then cast: the inflow of capital was sharply curtailed. It fell 60 per cent in Argentina in 1981, 75 per cent in Chile in 1982 and over 100 per cent in Uruguay in 1982 (see line 1, table 6).

It is difficult to exaggerate the adverse impact which such a shift in net capital flows had. Indeed, once interest and other factor payments are deducted from net capital flows, instead of receiving resources from the rest of the world, the three Southern Cone countries became net exporters of resources in the year they were finally forced to devalue (see line 3, table 6). The net transfer of resources was negative and on the order of 20 per cent of exports in all three countries (see line 4 of table 6), after having been strongly positive the year before. Indeed, it was because of such strong capital flows that aggregate demand could be maintained during phase II despite the generally poor terms of trade and the lag in the exchange rate.

Put differently, the shift in net resources transferred in the year of the devaluation was the equivalent of a deterioration in the terms

Figure 2

Exports, Net Transfer of Resources and  
Financing Available for Imports (Net)





of trade by 25 per cent in Argentina, 50 per cent in Uruguay, and 80 per cent in Chile (see line 4 of table 6). In other words, this meant, for example, that Chile — instead of being able to import 80 per cent more than the amount given by its export earnings because of the positive effect of the net transfer of resources (as in 1981) — had financing available which allowed it to import but 75 per cent of the value of its export earnings in 1982, because the net transfer of resources was negative. (See graph 2.) Such was the impact of the shift in capital flows on the net transfer of resources.

Given the lag in the exchange rate, the unprecedented reduction in capital inflows, and finally, the severe internal recession and accompanying domestic financial crisis, there was no alternative but to abandon the policy of automatic adjustment with a pre announced exchange rate, and to proceed to a massive devaluation. Not only was there no longer any confidence in the sustainability of the exchange policy but, once capital flows were curtailed, resources (reserves) had finally been run down to finance the deflation. Hence, there was no longer any practical alternative but a sharp increase in the exchange rate.

Such maxi-devaluations were followed by sharp increases in the rate of inflation in all three countries. Nevertheless, the intensity of such inflation was considerably less than the devaluation, so that competitiveness tended to recover, and the real exchange rate experienced sharp improvement (see table 4 once again).<sup>23</sup> To be sure, thanks to the recession, the quantum of imports fell so sharply that by 1983 the deficit in current account in all three countries had been sharply reduced (from almost 90 per cent of the value of exports in Chile in 1981 to less than 25 per cent in 1983; from almost 50 per cent in 1980 in Uruguay to 7 per cent in 1983; and in Argentina from well over 40 per cent in 1980 and 1981 to just over 20 per cent in 1983). Moreover, all three countries had come from very severe deficits in their balance-of-trade in 1980 and in 1981 to trade surpluses in 1982. Once again, the basis of these improvements was almost exclusively limited to the extraordinarily sharp reduction in the quantum of imports which the recession entailed. This reduction was 45 per cent in the two years 1982 and 1983 in Chile, 55 per cent for the same period in Argentina and 63 per cent in Uruguay. A recession is of course an extraordinarily rapid method of lowering imports, but it does so at the cost of a severe contraction in output.

Consequently, in the two or three years of this third phase in the Southern Cone countries, output fell some 10 per cent in each of the three countries (as opposed to 4 per cent in the rest of the region) and unemployment sharply increased.

Finally, despite the fact that the inflow of foreign capital was sharply curtailed in these years, the level of foreign debt was still extraordinarily high by the end of 1983. The ratio of foreign debt to the value of all exports of goods and services varied from a low of 3.3 in Uruguay to a high of 4.5 in Argentina. This, of course, compared quite unfavorably with the average of 2.7 for the rest of the Latin American region. To be sure, the Southern Cone countries had also been among the most highly indebted countries of Latin America when the neoconservative experiences began.

What is remarkable is that they should not have slowed their indebtedness in the course of eight to ten years of strong export growth and seeming allegiance to the principle of strict financial discipline. That they should still stand out among the most indebted countries of the region in 1983 does not speak well of the economic liberalization policies which they pursued, and, in particular, their policy of financial liberalization. The latter seems to have heightened rather than reduced their dependence on foreign savings and consequently made them all the more vulnerable to swings in the international economy. Now they had to be prepared to offset unexpected movements in capital accounts as well as in their terms of trade. Only as the level of debt approached more modest proportions might financial liberalization have given them more freedom to cope with the external disequilibrium they faced in later years. Instead, in the face of an already unduly high level of debt, rapid financial liberalization added a further and critical element which would serve to accentuate rather than attenuate unexpected movements in their external accounts. Adjustment was thus forced upon them in large part (maxi-devaluation plus severe recession), rather than being a policy which they deliberately chose. The over indebtedness of phase II thus eventually led to the capital reversals and overadjustment of phase III.

## **F. Conclusions**

One must distinguish between two types of stabilization policies: those which are intended principally to overcome internal disequi-

libria (inflation and/or recession), and those designed to overcome external disequilibria (associated with deficits in the balance-of-payments). The most important distinction between the two is that the former need not be faced — inflation can be lived with indefinitely; whereas the latter, that is to say, attention to external disequilibria, cannot be put off. The balance-of-payments is a binding restriction rather like a budget constraint. Adjustment to it is a necessity.

Moreover, precisely because inflation can be endured, depending solely on the country's tolerance, there is no reason, at least in theory, why an anti-inflationary stabilization policy need reduce output. Recession is all too often the (unwanted) result of a stabilization policy, but this is not inevitable. By contrast, adjustment policies have an unavoidable cost for the country. Adjustment to an external disequilibrium requires that the quantum of goods available to the country must decline in order to allow it to meet its foreign commitments. This is unavoidable. What is avoidable, though unfortunately it often accompanies adjustment processes, is a decline in output. Certainly the decline in output is by no means a necessary nor desirable condition for reducing the goods available to the economy. Quite the contrary, the optimum adjustment policy would maintain the rate of growth of output but reorient it from domestic to foreign usage. Exports would increase and imports would decline, the latter being substituted, as needed, by domestic production. And in the course of time, the output of tradeables would expand in relation to non-tradeables. Thus while adjustment inevitably implies a worsening — or at least a slower growth — of the standard of living, it does not require a decline in the rate of growth of output. Hence, the challenge which faced the Southern Cone countries in the second half of the seventies and early eighties was to avoid the recession which unnecessarily accompanies anti inflationary stabilization policies or balance-of-payments adjustment processes. So much for first principles.

The first seven conclusions which follow focus on the experiences and the lessons to be derived from the experiences of anti inflationary stabilization policies in the Southern Cone countries. The last three conclusions will refer to their adjustment to external disequilibria.

1. It is both theoretically and empirically necessary that a decline

in the rate of inflation be accompanied, sooner or later, by a deceleration in monetary growth and a reduction in the fiscal deficit. But a stabilization policy will be successful only to the extent to which the remaining principal variables — that is to say, prices, wages, exchange rates and interest rates — decelerate at the same pace. Theoretically, the mere announcement of the deceleration in the inflation rate could be enough to assure that the remaining variables adjust instantly and in this way harmonize their behavior with the programmed monetary and fiscal policy and the projected inflationary goal. In practice, however, inflationary expectations do not adjust instantaneously. For one thing, the public is normally rather skeptical. It wants to see results before believing, at least before believing fully that inflation is going to fall as fast as the government projects. Because of this inertia in the adjustment of expectations, the level of prices normally remains above that consistent with the economic policy, thus leading to recession. Moreover, it is often the case that, in addition to wanting to lower inflation, policy aims at correcting relative prices: the exchange rate, the prices of public services, and/or the prices of agricultural products in relation to industrial goods. This was the case in the three experiences we have examined. Unfortunately, the increase in these heretofore repressed prices is often considered by many private agents to be the single best indicator of probable inflation, and not simply the expression of a needed corrective adjustment in relative prices. This being so, inflationary expectations will exceed the inflationary goal implicit in economic policy, thereby making policy too restrictive for such a level of expectations, and therefore generating a recession.

Hence, while it is certainly true that in order to reduce inflation it is imperative that money supply be controlled and the fiscal deficit reduced, no stabilization policy worth the name can be based on these instruments alone if it wishes to avoid the costs of recession. Such a policy must necessarily try to harmonize, or guide, or control, but certainly not repress the movement of all of the principal economic variables (prices, wages, exchange rate, interest rate, etc.), in such a way that it be compatible with the rate of inflation implicit in the monetary and fiscal policy. If some variables adjust more rapidly than others, a recession will ensue — normally a recession with regressive distributive consequences (at the expense of those variables which adjusted their prices downwards more rapidly).

2. The anti-inflationary stabilization programs in the Southern Cone followed two approaches each of which focused on and controlled some of the principal economic variables, but not all. During the first phase, efforts were centered on direct control of the money supply and wages. Such controls, together with natural market forces, were expected to bring internal prices rapidly into line with the programmed inflationary goal. During the second phase, efforts centered on controlling the movements of the exchange rate, and by means of this mechanism decelerating the rate of growth of prices. In both cases important strides were made in reducing inflation. Nevertheless, the cost was high in each, inasmuch as the free variable, prices, adjusted far more slowly than the controlled variables, thus generating significant disequilibria.

3. In the first phase the principal disequilibrium emerged in the market of goods. Prices closed up far more than wages, giving rise to a severe, demand-deficient recession in Chile and to stagnation in Argentina. Only Uruguay was spared, thanks to its very high level of public investment and to the positive evolution of external demand for its products.

4. Whether or not recession is avoidable under stabilization policies, there is no reason why the losses should be distributed unequally. Yet the fact of the matter is that the "belt tightening" during phase I proved to be quite uneven in all three countries. Income was sharply redistributed against wage earners, as can be seen by the very sharp fall in real wages (much sharper than the decline in the growth of national income), and, in the case of Chile, this was further accentuated by an unprecedented increase in the unemployment rate, leaving it two to three times above historic rates. That the distributive cost of the stabilization policy was borne so unevenly was the result of the specific policy instruments applied during phase I: the policy of allowing inflationary expectations to operate freely in the goods market, while controlling wages and pursuing a tight monetary policy. Such expectations led producers to set prices well above what was consistent with economic policy. In this way, prices overshot equilibrium and proved to be far above what wage costs alone would have led them to be.

5. In the second phase, the principal disequilibrium emerged in the market for foreign exchange, since domestic inflation declined much more slowly than the rate of devaluation. This lag in the

exchange rate was in turn the result of the convergence of domestic prices and interest rates to international ones at a much slower rate than might have been expected had the "law of one price" been effective. Contrary to what was expected, the initial tendency was for goods and international loans to be placed at prices (or interest rates) much closer to their domestic counterparts and not at their long-run or international values (their cost). In short, initial convergence was not downwards towards international prices and costs but upwards towards domestic prices.

6. The lag in the exchange rate during phase II finally led to a serious disequilibrium in the balance-of-payments, eventually giving way to a sharp recession. Initially, recessionary symptoms were hidden by the unusually strong inflow of foreign capital; but once such flows slowed, a sharp recession proved inevitable. The failure of domestic prices to decelerate at a pace similar to the rate of devaluation worsened the exchange rate lag, thereby rendering ever less plausible the continuation of the exchange policy and the stabilization program based on it. Lack of confidence contributed to the eventual slowdown in the inflow of foreign capital and, hence, finally made the abandonment of the exchange policy inevitable. Massive devaluations were thus made necessary in order to close the huge gap which existed between domestic and foreign prices.

7. While the second phase lasted — that is to say, up until the maxi-devaluations — the distribution of income recovered partially or came to approximate its earlier concentration. Such an improvement took place because employment (Chile and Uruguay) and/or real wages (Argentina and Chile) tended to rise. Real wages recovered sharply in Chile, as they were readjusted in accordance with past, not current, inflation, which was decelerating rapidly.

8. While it is undoubtedly true that capital inflows can mitigate balance-of-payments difficulties and thus avoid significant exchange rate variations, it is likewise true that the sudden reduction in such inflows can itself create or accentuate an external disequilibrium, forcing even more sizeable adjustments on the balance-of-trade. This is so because capital movements are sensitive not only to interest rate differentials and exchange lags but also, and more importantly, to uncertainty concerning the country's capacity to service its foreign debt. When such uncertainty leads to sharp declines in production and in capital flows, adjustment must take place all the more rapidly.

These dangers manifested themselves clearly in the three Southern Cone experiences. Capital inflows proved to be highly procyclical. During the period of programmed devaluations, capital inflows were sufficiently strong to minimize, indeed more than compensate, the negative effects on output of a lag in the exchange rate, and so to maintain strong aggregate demand. Inversely, once doubts were created as to the country's capacity to service its debt, capital inflows diminished sharply, thus forcing exceptionally rapid and strong adjustment to external disequilibrium. Thus not only was there overindebtedness (excessive capital inflows) in phase II, as can be seen by the extra-ordinarily high ratio of debt to exports reached in all three countries, but there was overadjustment in phase III. In this last phase, all three were forced to adjust their economies not only to a persistent external disequilibrium, due to the lag in the exchange rate, but also to the procyclical reduction in capital inflows, which, however transitory, had to be taken into account.

Thus, whereas in the last year of phase II, the combination of capital inflows and variations in the terms of trade raised these countries' capacity to import to about 20 to 40 per cent above their level of exports, once adjustment was forced upon them and capital inflows receded, the net transfer of resources which they were forced to make was the equivalent of 25 per cent of their exports. As a result, in a twelve month period, each of them was forced to reduce imports or increase exports by the equivalent of some 50 per cent of the value of exports. Moreover, since these adjustment experiences took place in the course of a major international recession, the brunt of the transfer had to be borne by a reduction in imports and not an expansion of exports. Given such a sharp reversal in their capacity to import, it is not surprising that in the ensuing years (1981-1983) these countries' output fell about 15 per cent.

9. In the face of external disequilibria, it normally would be desirable to be able to draw on additional capital inflows to soften and prolong the adjustment experience, so that adjustment would take place via an expansion of tradeables and not simply via a reduction of output. Yet the three Southern Cone countries were so heavily indebted to begin with, that they ceased to be able to draw on capital flows as needed; rather, capital flows became a variable to which they were forced to adjust. It is true that a devaluation or "switch-

ing" policy, taken earlier or more sharply, might have succeeded in reducing imports at a lower cost in output. However, by the time devaluation was forced upon these countries, disequilibrium was so large and capital inflows so reduced, that the devaluation was much less effective than it might otherwise have been.

10. Thus, unlike a price stabilization program, where a "shock" policy may be efficient especially in dealing with hyperinflation, there can generally be no efficient "shock" adjustment to external disequilibrium. Efficient adjustment implies changes in real, not simply in monetary, variables. Thus gradualism is central. Not only must the output of non-tradeables decline, which occurs rapidly, but the output of tradeables must rise, and this happens slowly; not only must the volume of imports be reduced, which happens quickly, but exports and import substitutes must increase, and this takes time.

Because of the magnitude of the disequilibrium they faced and the brief period of time in which they had to address it, the adjustment of the Southern Cone countries was anything but efficient. Its results were based almost exclusively on expenditure reduction (controlling demand, which can be speedy) rather than on expenditure switching (supply and production shifts, which are necessarily much slower). This, of course, is the worst of all possible adjustments.

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1/ This controversy occupied a good part of the debate concerning inflation right through the end of the '60s. The literature is extensive. See, for example, the articles by Roberto de Oliveria Campos, David Felix and Joseph Grunwald, in A. Hirschman (ed.), *Latin American Issues* (Twentieth Century Fund, 1961); the articles in the Rio de Janeiro Conference on "Inflation and Economic Growth," published in the book by W. Baer and I. Kertenetzky (eds.), *Inflation and Growth in Latin America* (Yale University Press, 1964); and the 6 volume study by ECLA, *Inflation and Growth* (mimeograph), a summary of which was published in the *Economic Bulletin for Latin America* (February 1962) entitled "Inflation and Growth: a Summary of the Experience in Latin America."

2/ The quantitative identity states that money (M) multiplied by velocity (v) is equal to the level of prices (P) multiplied by the value of output (Q). Consequently it is true by definition and by differentiation that  $\dot{M}/M + \dot{v}/v = \dot{P}/P + \dot{Q}/Q$ . The quantitative theory in its traditional and simple form states that v is relatively constant. Consequently,  $\dot{M}/M = \dot{P}/P + \dot{Q}/Q$ . If we suppose, at least for the short-run, that product remains constant  $\dot{M}/M = \dot{P}/P$  (the more well-known expression of the quantitative theory). The quantitative theory showed excellent explicative power in the period 1950 through 1970 for the three countries. Given the growth in money and product, the theory would have predicted a rate of inflation for the period of 20 per cent in Argentina (as opposed to 24); of 33 per cent in Chile (as opposed to 30), and of 20 per cent in Uruguay (as opposed to 29).

3/ Friedman himself states that this is the single most important problem to be resolved in modern macroeconomics. See his article, "A Theoretical Framework for Monetary Analysis," *Journal of Political Economy*, March/April 1970.

4/ To be sure, the demand for money does not depend solely on inflationary expectations, but also, among other things, on its alternative uses. More specifically, the creation of an internal capital market created financial instruments of a highly liquid nature, paying good interest rates, and this affected the demand for money. At the same time, the supply of money was not easy to control either.

5/ Thomas Sargent makes this point quite explicitly, in arguing that the costs of reducing inflation are proportional not to the rate of past inflation (the theory of inflationary "momentum") but rather to expected inflation (rational expectations). Thus, should the public believe that there has been a change in the rules governing fiscal and monetary policy (in short, a permanent change in the regime) and not solely a change of policy within those rules (a transitory change), the cost of reducing inflation can be quite low. He cites as specific examples the cases of hyperinflations which were abruptly stopped after the First World War in Germany, Austria, Hungary and Poland and in which recession was either slight or nonexistent. See his paper, "The End of Four Big Inflation," in NBER Conference Paper No. 90 (National Bureau of Economic Research, January 1981, mimeograph).

6/ This is not to suggest that there were not other motives behind wage controls. For example, in Uruguay many argued explicitly that wages ought to fall in the short-run in order to increase profit margins and thus raise the heretofore low levels of savings and investment. It is also possible that some have believed that real wages exceeded equilibrium levels during the periods of Peron in Argentina and Allende in Chile (the periods immediately preceding the onset of neoconservatism). In point of fact, this was not the case in Chile, since real wages had fallen already by over 15 per cent with respect to 1970 levels in Allende's last year. The argument is somewhat more plausible in Argentina, since real wages grew 11 per cent between 1970 and 1975, whereas per capita output grew but 8 per cent. Nevertheless, given the rather small magnitudes involved, the need for adjustment would have been minimal. Finally, there is no doubt that union power was looked upon with great suspicion by the neoconservatives, for both political and ideological reasons, since unions had been an important base of support for the preceding governments in Argentina and Chile. Moreover, the neoconservatives tended to look upon labor unions as no more than instruments of incipient monopolistic control. Therefore, they tended to believe that wages had been raised artificially for a long time.

7/ The control of the exchange rate was justified for another reason: the need to have some numeraire or reference price in the economy, with respect to which all other prices could freely adjust.

8/ It is important to note that in none of the cases analyzed did the deterioration in the terms of trade imply a loss greater than the equivalent of 6 per cent of GNP. A similar decline in real wages should have maintained income distribution. However, inasmuch as the wage decline was far in excess of this, other factors than the adjustment to the external shock are needed to explain the bulk of the fall in real wages.

9/ The latter typified the situation of Chile at the end of 1973. The repressed inflation was so severe that a generalized shortage of products emerged, not so much because output had declined but because there was an excess of money, capable of buying far more than the economy was able to produce at the prevailing controlled prices.

10/High interest rates affected not only inflationary expectations but production costs as well, pressuring prices upwards at least in the first instance. In the short-run, rather than inducing the sale of inventories, high interest rates and increased financial costs tended to be passed on to prices. See D. Cavallo, "Loss efectos recesivos e inflacionarios iniciales de las politicas monetarias de estabilizacion," Banco Central de la Republica Argentina, *Ensayos Economicos*, No. 4, parte 2 (Buenos Aires, 1977).

11/Referring to Frenkel and Ramos, Foxley pointed out: "In Argentina, Chile and Uruguay double and triple digit inflation was experienced before and during the first years of the stabilization program. It is precisely this type of context which is characterized by imperfect information, by uncertainty with respect to the future evolution of prices, and by huge risk, and in which the above factors become determining elements of the price decisions adopted by firms. Profit margins then become a function of expected inflation, and of the uncertainty and risk involved. During the phase of very high inflation, of maximum uncertainty and disequilibrium in the economy, prices become relatively autonomous, not only with respect to demand but also with respect to cost pressures." See A. Foxley, "Experimentos neoliberales en America Latina," *Estudios CIEPLAN* No. 7, marzo 1982; R. Frenkel, "Decisiones de precios en alta inflacion," en *Estudios CEDES*, Vol. 2, no. 3 (Buenos Aires, 1979); and J. Ramos "Inflacion persistente, inflacion reprimida e hiperstanflacion," en *Cuadernos de Economia*, diciembre 1977.

12/Farmers had fewer possibilities of setting their prices in accordance with inflationary expectations, either because farm goods are perishables subject to high storage and conservation costs or because this is a more competitive sector. The fact remains that agricultural prices did not improve to the extent expected.

13/To be sure, this is not a situation which can be maintained in the long-run, at least in competitive markets, for each firm can improve its profits by lowering its prices and thus increasing its sales. Nevertheless, in periods of recession, as in this case, with prices in disequilibrium, this effect operates slowly. For the firm tends to see the demand of its products as much less elastic to price than what it really is. For a detailed explanation of this point, see J. Ramos, "The Economics of Hyperstagflation," *Journal of Development Economics*, December 1980.

14/The employment problem was less severe in Argentina, since output there did not fall but simply stagnated. Moreover, in Argentina other factors came into play, as was pointed out earlier. For example, foreign labor was affected more than domestic labor; there was an important increase in self-employment; and fewer people than before continued to hold two jobs.

15/Strictly speaking, the rate of inflation would fall to the algebraic sum of the devaluation and the rate of international inflation. This sum would be the equivalent of the inflationary goal.

16/Rather than becoming equal, these should approximate each other, for in the case of interest rates a surcharge would have to be added to cover country risk and the higher cost which domestic financial intermediation might entail. In the case of goods, one would have to add the cost of shipping, tariffs, and additional domestic retailing costs.

17/The data in the table to which the text refers correspond to the central government deficit. Were provincial governments' deficits to be included — and these are important in Argentina — the deficit would increase by over 50 per cent.

18/See C. Rodriguez, "Políticas de estabilización en la economía argentina 1978-1982," *Cuadernos de economía*, No. 59, abril 1983.

19/To be sure, were the lag in the exchange rate to have been compensated by an equivalent improvement in the terms of trade, no problem would have emerged. For the higher cost of domestic production would have been compensated by the increase in the international price of exports, thus keeping these competitive. While there was a certain improvement in the terms of trade of Argentina in this period, it was far from sufficient to compensate the strong increase in costs. In Chile the terms of trade worsened, so that the problem was accentuated rather than relieved. In Uruguay the terms of trade remained virtually constant.

20/For example, a product which sold for US \$100 in New York would cost US \$110 in the Southern Cone, once transport costs were added. Were the tariff 18 per cent, its domestic price would be no less than the equivalent of US \$130. On the other hand, were one to export the comparable domestic good, its selling price in New

York would have to be no more than US \$100. This implies that its price in the Southern Cone, before transport, would have to be no more than US \$90. Indeed, it would have to cost even less, were the U.S. to place a tariff on the good. Hence, there would exist a wide range of prices between US \$90 and US \$130 within which the domestic good could fluctuate, without its being exported nor facing the competition of comparable imported goods.

21/However, thanks to the strong inflow of capital and the consequent high level of aggregate demand, domestic output tended to rise notwithstanding its loss of market share.

22/There is an asymmetry, both in theory and practice, between these two options during the transition. The option of automatic adjustment or deflation would be limited by the fact that nominal interest rates can never be negative, inasmuch as the mere holding of money pays a zero nominal rate of interest. This built-in inflexibility in the nominal rate of interest implies that deflation will automatically increase real rates of interest, for nominal rates of interest would necessarily have to be positive. So if domestic prices actually fell, because of deflation, real interest rates and financial costs would be greater. Hence, deflation would create its own brake in the form of real interest rates, which would tend to force the bulk of monetary contraction on output rather than on prices. This problem would be more serious, the greater the lag in the exchange rate and the greater the needed absolute fall in prices.

23/If I insist upon this point, it is simply because, notwithstanding their recognition that there was an important lag in the exchange rate which needed correction, many argued that a devaluation would be ineffective. They believed that it would be wiped out very rapidly by a similar rise in the rate of inflation. To be sure, a devaluation could set off a new inflationary spiral. Yet this need be so only if the starting point were one of equilibrium, in which case any attempt to improve the trade balance via a devaluation soon would be limited by a fully utilized productive capacity, thus leading to a price rise that would rapidly eliminate whatever transitory balance-of-trade improvement had taken place. But in such circumstances, a deflation would also prove useless. For lower prices would raise demand, foreign and domestic. Since a starting point of equilibrium is posited, prices would begin to rise, wiping out the deflation and the transitory gains in competitiveness and in the balance-of-trade. However, a

devaluation of the exchange rate or deflation can be effective if the starting point is one of disequilibrium, in which domestic prices are above international ones. The resolution of such a disequilibrium requires a real depreciation. Whether this is best achieved by raising the prices of international goods to those of comparable national ones (devaluation) or by lowering the prices of domestic goods to international levels (deflation) is another question. Either way is theoretically feasible, if the starting point is disequilibrium. Thus, though the argument against devaluation was premised on a continuing equilibrium, in the situation, a lag in the exchange rate implied precisely the contrary, namely, that domestic prices were above international levels and were thus in disequilibrium.

## CHAPTER 8

### *Debt and Adjustment: The Experience of South Asia & Sub-Saharan Africa\**

Shahid J. Burki

#### Introduction

This paper has four parts. The first provides the main features of what has come to be known as the developing countries' debt problem. These features — the size of the debt, its origins, the burden it currently imposes on the developing world, etc. — will be described in both quantitative and qualitative terms. The second part of the paper will attempt to answer the questions: How did the situation develop? Did the developing countries stumble into this situation carelessly or is the situation the result of circumstances over which they have had little control? It is, of course, an oversimplification to talk of the debt problem as if the entire developing world is faced with it simultaneously. It is more useful to look at the problems from several regional perspectives — the perspectives of Latin America, of East Asia and South Asia, of the oil-exporting countries of the Middle East and North Africa, of the sub-Saharan African countries, and of the semi-developed countries of South and East Europe. Part three of this paper will provide a brief overview of some of these regional perspectives and then go on to discuss the situation in the low-income countries of Asia and Africa. Finally, part four will provide an assessment of how the situation in low-income countries may develop in the years ahead.

#### I. The Magnitude of the Problem

The World Bank estimates the external liabilities of developing countries in 1983 at \$810 billion.<sup>1</sup> The table below shows the

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\* *The views expressed in this paper are those of the author and do not necessarily represent those of the World Bank.*

**Table 1: Growth in Developing Countries' Debt**  
(\$ billion)

	1980		1981		1982		1983	
	Amt.	%	Amt.	%	Amt.	%	Amt.	%
Medium and Long-term	466	76.8	523	74.6	574	74.9	635	78.4
of which public	(174)	(28.7)	(189)	(27.0)	(208)	(27.1)	(225)	(27.8)
of which private	(292)	(48.1)	(334)	(47.6)	(366)	(47.8)	(410)	(50.6)
Short-term	132	21.7	164	23.4	170	22.2	145	17.9
IMF	9	1.5	14	2.0	22	2.9	30	3.7
	607	100.0	701	100.0	766	100.0	810	100.0

Source: Computed from *The World Debt Tables, 1983-84* (Washington, D.C.: The World Bank, 1984).

build-up of developing countries' outstanding debt over the years of crisis. The most interesting thing about these statistics is the sharp decline in the rate of increase in developing countries' external liabilities: they increased by 15 per cent from 1980 to 1981, but by only 9 per cent between 1981 and 1982 and by 6 per cent between 1982 and 1983. The decline in the rate of increase of short-term debt was also significant: it increased by 24 per cent between 1980 and 1981 but by only 4 per cent between 1981 and 1982. Between 1982 and 1983, outstanding short-term debt liabilities declined by nearly 15 per cent. Consequently, the share of short-term liabilities in total outstanding debt declined from 22 per cent in 1980 to less than 18 per cent in 1983. This sharp decline in the rate of debt build-up in developing countries is essentially the result of reluctance on the part of commercial lenders to continue to provide additional monies. The decline was compensated to some extent by purchases from the IMF by developing countries: these increased from \$9 billion in 1980 to \$30 billion in 1983. The IMF's share in developing countries' outstanding liabilities more than doubled: from 1.5 per cent in 1980 to 3.7 per cent in 1983.

The implied increase in the rate of outstanding debt over the last dozen years is high in nominal terms — on the order of 20 per cent per annum since 1972. Since the rate of growth of the GNP of the developing countries was much lower, the ratio of debt to GNP increased during this period, from about 14 per cent in 1970 to 27 per cent in 1983. But even the ratio of debt to national income reached in 1983 is not very high — it has been exceeded in the past

by many countries. Another way of looking at the burden of total outstanding debt is to compare it to total exports. The total exports of developing countries in 1983 were valued at about \$500 billion, which means a debt to export ratio of less than 1.6. It has been estimated that the debt to export ratios were much higher in the early years of this century — on the order of 5.2 for Latin America and 2.4 for India.<sup>2</sup>

What these ratios suggest is that it is not the quantum of outstanding debt that has created a critical situation. The difficulty is in servicing the debt. Servicing has become a problem because for many countries a large proportion of the debt was obtained on variable interest rates, and these rates reached unprecedented levels during the early 1980s. For developing countries taken together, the proportion of loans contracted at variable rates increased from only 10 per cent of all debt in 1970 to 40 per cent in 1980. At the same time, short-term interest rates increased from less than 5 per cent in the early seventies to over 20 per cent a decade later. Consequently, debt service ratios increased from 13.5 per cent in 1970 to nearly 21 per cent in 1982.<sup>3</sup> But even these levels are not high enough to produce a crisis. The developing countries' payment situation came to be seen as a crisis because for some of them the debt service ratios were far above the average for the Third World: in 1981 they were 33 per cent for Brazil, 28 per cent for Mexico and 27 per cent for Chile, and about twice as high a year later for these three countries. And, as pointed out in a recent study by the IMF staff, in comparison to some earlier situations "the emergence of serious Bank debt problems since mid-1982 occurred much more abruptly..."<sup>4</sup> It was this abruptness that produced the perception of a crisis.

## **II. How Did the Crisis Come About?**

There are two sets of explanations for why the crisis occurred so suddenly and, for many, so unexpectedly, in the summer of 1982: the first, the more conventional one, is provided in economic and financial terms, whereas the second — the more novel one — takes a somewhat broader view and includes also political and psychological factors.

There is no need to rehearse at length the economic and financial

events that brought many developing countries to the brink of bankruptcy. Some of these developments — excessive reliance on variable interest borrowing and a steep climb in the rate of interest carried by such borrowing — have already been mentioned. But there were additional circumstances, the most important of which were the sharp economic downturn in industrial countries and the resultant decline in world trade. The value of developing countries' exports, after having increased at the annual rate of 8.2 per cent in 1965-73 and 4.2 per cent in 1973-80, stagnated in 1980-82. This happened because of a precipitous fall in commodity prices. The sharpest declines in terms of trade occurred for low-income Asia and middle income oil-importers — two groups of countries for whom the problem of debt became very serious (see table 2).

Even with such drastic changes in the terms of trade of groups of developing countries, outstanding debt need not have become a problem if flows of capital had been maintained at past levels. After all, low-income Africa and middle-income oil-importers had suffered terms of trade declines in the 1973-76 period, but they were able to sustain a large burden of debt because they were then receiving flows of concessional and non-concessional capital. But in the second period — particularly after 1981 — commercial flows declined substantially and thus brought about a situation of crisis.

To understand why commercial flows dried up suddenly, we have to look beyond the realm of economics. The political aspects of the debt problem are as important as its economic and financial aspects. One fact which must be kept in mind is that it takes a long time to build political confidence, but it can be destroyed quickly. Thus the political implications of the actions taken by governments, commercial banks and international organizations must be understood carefully and fully. Second, the nature of the financial relationship between developing countries on the one hand and creditor nations and institutions on the other has evolved in such a way that, over time, the number of parties associating themselves in these transactions has increased. As each new player has been brought onto the stage, it has increased the confidence of the creditors in the security of their loans. This increase in confidence was to the advantage of the borrowers, since it reduced the cost at which they obtained financing. But at the same time, as there was an increase in the number of parties involved in the financial relationship, it became more

**Table 2: Changes in Terms of Trade of Developing Countries  
1973-82 (per cent) a/  
1978 = 100**

<u>Countries</u>	<u>1973-76</u>	<u>1979-82</u>
Low-income		
Asia	12.1	-3.2
Africa	-15.3	-13.8
Middle-income		
Oil-importers	-9.5	-10.7
Oil-exporters	59.9	31.8

Note: a/ Measured by ratio of export unit value index over import unit value index.

Source: The World Bank, *World Development Report, 1983* (New York: Oxford University Press, 1983), Table 2.4, p. 13.

difficult to resolve whatever problems occurred. Developing countries now live in an extended financial family, a situation very different from the one that existed before the Second World War.

It is possible to divide the financial dealings between international money markets and developing countries into four periods, although such a historical outline is of course highly simplified. The first period ended with the Great Depression, up to which time commercial banks mostly underwrote the bonds floated by developing countries. The second lasted from the end of the war to the early seventies, when commercial banks took the back seat while official flows — a great deal of them from multilateral institutions — increased at a rapid rate. The third period began with the 1973 increase in oil prices, when commercial banks came upon a large quantum of resources received as deposits from the oil-exporting countries. The third period ended rather suddenly in the summer of 1982, when “involuntary lending” by commercial banks replaced the voluntary lending of the seventies. This was the beginning of the fourth period.

With each period, institutional intermediaries and direct institutional involvement have tended to become more complex. In the period before the Great Depression, the banks performed the role of underwriters, leaving developing countries direct access to the bond markets. The development of the multilateral financial system

after World War II brought into being a set of institutions that interposed themselves between the markets and the developing countries. After 1973, commercial banks entered the field on their own, undertaking direct lending to developing countries quite independent of official institutions. Since 1982, various lenders have attempted to work together within a framework of policy reform that is first agreed upon with the borrowers.

This final transition — from the *laissez-faire* period of the seventies to the highly managed period that began in 1982 — was not produced suddenly by a deterioration in the financial situation of the developing countries that had borrowed heavily from the international financial markets. Neither was this change the consequence of some sudden calamity that befell the principal providers of finance to developing countries. Instead this move was the product of a loss of confidence on the part of the commercial banks in the ability of their debtors to service outstanding debt. This confidence was lost largely because of a series of political developments that began with the turmoil in Poland and culminated in the Falklands conflict in the South Atlantic.

The crisis in Poland reduced the confidence of the American and European bankers in the country's ability to keep on servicing its outstanding debt. The banks balked at continuing a steady flow of commercial money to Poland, but the East European country was saved from bankruptcy when several European governments and that of the United States provided tacit repayment guarantees to the commercial banks. This kind of tripartite understanding between the borrowers, commercial banks and governments of industrial countries, first reached at the time of the Polish crisis, was dealt a serious blow in its further application, by the United States' decision to support Britain rather than Argentina in the Falklands conflict of May-June 1982.

"As is well known, several American banks had an exposure in Latin America well beyond their capital and reserves, an exposure that could be viewed as prudent only if there was an expectation that the United States would come to the aid of those countries in the event that the region fell into a serious payments crisis."<sup>5</sup> The United States' support for Britain exploded this assumption, causing the flow of funds to the countries of Latin America virtually to dry up. It was not too long after this that Mexico suspended

payments to its creditors. By the end of 1982, this same fate befell Argentina, Brazil and Chile. In December 1982, these four countries together had \$162 billion of outstanding loans to commercial banks out of a total of \$363 billion owed by all developing countries. With as much as 45 per cent of the outstanding loans in jeopardy, it is not surprising that the banks began to speak of developing countries' debt crisis.

As the Polish crisis had introduced industrial governments into what had been understood as a relationship strictly confined to the borrowers (governments as well as non-government entities) and commercial banks, the financial problems of Latin America brought yet another partner into this expanding relationship. The Mexican problem was resolved by the entry of the International Monetary Fund into the equation. It was a remarkable performance on the part of the Fund that saved Mexico from bankruptcy; and this created the precedent for the Fund to enter into similar arrangements with Brazil, Chile and Argentina when these countries were faced with situations not dissimilar from that of Mexico in August 1982. By now the "involuntary lending arrangements" between the countries in debt difficulties and commercial lenders have become a standard component of the adjustment programs the Fund has initiated in a number of heavily indebted countries.<sup>6</sup>

Whether this approach is the right solution to the developing countries' debt problem is a question that also deserves a political answer. It is possible that the confidence of the commercial banks would also be shaken in this type of arrangement. The Falklands crisis demonstrated that the protective umbrellas the governments had erected for their commercial banks could easily be taken down. The umbrellas were not real; they were really sets of assumptions which the commercial banks took on at the urging of their governments. Likewise, the "involuntary arrangements" they have recently entered into are also based on a series of assumptions which must have been shaken seriously during the prolonged political battle that was waged in the United States Congress over the passage of the IMF quota authorization bill. The bill was passed, and for the moment the banks and their debtors have accepted the assumption that the United States and other industrial countries are prepared to use the expanded Fund resources to help institute adjustment programs in developing countries. There is a further assumption that

without these programs it would not be possible for the countries with large debt burdens to remain solvent in the long-run.

The fact that Mexico's debt problem surfaced suddenly is a vivid illustration of the importance of the political and psychological factors that govern the relations between industrial and developing countries. In the October 1980 issue of *Euromoney*, Mexico, Brazil and Argentina were ranked 20, 23 and 25 respectively in terms of country risk.<sup>7</sup> These three countries were to experience exceptional problems not very long after that assessment was made. The external finance position of these countries did deteriorate in the months following the publication of these ratings, but the decline in their fortunes was not so significant as to warrant the kind of crises in which they found themselves.

This brief analysis of the politics of the debt problem has a clear implication: changes in political attitudes and assumptions can cause wide swings in the amount of capital that flows from industrial countries to the various groups of developing countries. But there is an asymmetry in these swings, in the sense that flows can be turned off suddenly but are slow to rise again.

### III. Regional Characteristics of Developing Countries' Debt Problems

There are a number of important differences in the way external debt became a problem — or, in some cases, did not become a problem — in various regions of the Third World. These regional characteristics can be viewed from a number of perspectives. Perhaps the three most interesting of these are: first, the rate at which the current account deficit increased over the last dozen years or so; second, the way in which this deficit was financed; and, third, the impact the financing of the deficit had on debt burden.

Table 3 shows that from 1970 to 1981 developing countries' current account deficit increased nearly tenfold, but the bulk of this increase occurred in the six-year period between 1975 and 1981. It was during this period that the shock delivered by two oil price increases had to be absorbed by developing countries. Since 1981, a rather dramatic decline has occurred in the level of the deficit; it declined by as much as 35 per cent over this two-year period. The period since 1981 was the period of adjustment, when country after country reduced the levels of their imports to bring them into line with the external resources that were now available. The level

of deficits accordingly declined. However, the severe retrenchment in imports also had a strong impact on the rate of growth of gross domestic products of several developing countries. The combined GDP of the developing countries is estimated to have increased by only 2 per cent in 1983 — a rate somewhat less than the increase in population. In all the developing countries taken together, therefore, there was a decline in per capita income in 1983.

The table also reveals some rather striking regional differences in the way these current account deficits grew and declined. For the low-income countries, the peak came a year earlier than for the middle-income countries (1980 as against 1981), but the decline was not as precipitous after this peak. For the low-income countries, the 1983 deficit was 76 per cent of that in 1980; for the middle income countries, the 1983 deficit was only 61 per cent of that in 1981. Putting it in another way, after the peak deficit was reached in the middle-income countries, the adjustment came rapidly, with the deficit declining at a rate of over 22 per cent per annum. For the low-income countries, the adjustment came at a much slower rate and over a longer period of time: at just over 9 per cent per annum after 1980. It is not surprising, therefore, that the burden of adjustment — from high levels of deficits that could be financed from external borrowing to a relatively low level that had to be sustained, since external flows were reduced to a trickle — was felt much more by the middle-income countries than by poor nations.

There is also quite a significant difference in the behavior of current account deficits in low-income Asia and Africa. For low income Asia, the 1983 deficit was only 53 per cent of the peak in 1980; for the poor countries of Africa, the peak was reached in 1981 but the decline thereafter was very small in nominal terms.

The lower section of table 3 provides estimates for current account deficits in 1980 dollars, whereby the real magnitude of adjustment can be gauged. We see now that in real terms, the 1983 current account deficit for all developing countries was only 64 per cent of that in 1981; for the middle-income oil-importing countries, it was 60 per cent of the peak; and for low-income Asian and African countries, only 53 per cent and 92 per cent respectively.

Two significant changes occurred in the way developing countries financed their current account deficits. Up to 1981, the year before the Mexican crisis, net capital flows to developing countries were much larger than their deficits, with the result that they made sizable

**Table 3: Developing Countries' Current Account Balances,  
Excluding Official Transfers  
(billions of current dollars)**

	<u>1970</u>	<u>1975</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>
All LDCs	-12.0	-36.9	-35.9	-31.3	-58.9	-125.0	-121.3	-81.2
Low-income								
Asia	-0.7	-2.7	-1.9	-5.4	-11.6	-6.8	-2.5	-6.2
Africa	-0.6	-3.0	-2.6	-3.0	-3.7	-5.9	-5.3	-5.5
	-1.3	-5.7	-4.5	-8.4	-15.3	-12.7	-7.8	-11.7
Middle-income								
Oil-importers	-7.5	-28.7	-21.8	-36.2	-56.2	-70.2	-62.1	-42.6
Oil-exporters	-3.2	-2.5	-9.6	13.3	12.6	-42.1	-51.4	-26.9
(billions of 1980 dollars)								
	<u>1970</u>	<u>1975</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>
All LDCs	-31.2	-57.6	-43.3	-34.2	-58.9	-125.9	-123.3	-80.6
Low-income								
Asia	-1.8	-4.3	-2.3	-5.9	-11.6	-6.9	-2.6	-6.1
Africa	-1.4	-4.7	-3.1	-3.3	-3.7	-5.9	-5.4	-5.4
	-3.2	-9.0	-5.4	-9.2	-15.3	-12.8	-8.0	-11.5
Middle-income								
Oil-importers	-19.6	-44.7	-26.3	-39.5	-56.2	-70.7	-63.1	-42.4
Oil-exporters	-8.4	-3.9	-11.6	14.5	12.6	-42.4	-52.2	-26.7
Deflator: 1980 = 100	38.4	64.1	83.0	91.7	100.0	99.3	98.4	100.6

Source: World Bank data files.

net additions to their reserves. In the three years up to 1981, developing countries added \$102 billion net to their collective reserve position. However, beginning in 1981, these reserves began to run down, since net financial flows were now much lower than current account balances. In the years up to 1983, developing countries' reserves declined by \$42 billion. The second important development was the significant decline in the share of net private flows in developing countries' financial receipts from a high of 53 per

**Table 4: Debt Service Ratios for All Developing Countries, 1970-82**

<u>Country group</u>	<u>1970</u>	<u>1980</u>	<u>1981</u>	<u>1982</u> a/
All developing countries	13.5	13.6	16.3	20.7
Low-income				
Asia	13.3	7.9	8.4	10.1
Africa	6.5	8.8	11.6	28.3 b/
Middle-income				
Oil-importers	14.0	14.9	18.0	23.0
East Asia	6.7	7.0	7.6	8.6
Latin America	13.0	33.3	39.6	53.2
Oil-exporters	13.9	13.0	15.7	19.1

Notes: a/ Estimated.

b/ The sharp rise in 1982 reflects the accumulation of arrears and does not allow for any rescheduling in 1982.

Source: The World Bank, *World Development Report, 1983*, (New York: Oxford University Press, 1983), Table 2.14, p. 21.

cent in 1978 and 1979 to 41 per cent in 1982 and only 32 per cent in 1983.

Once again, distinctions between various groups of countries help to clear the picture. The massive reserve build-up that occurred in 1978-80 was largely accounted for the oil-exporting countries, while the equally massive run-down occurred in the oil-importing middle-income countries. By the end of 1983, the reserves held by the middle-income countries were at dangerously low levels. The sources of finance used for meeting current account deficits also differ between groups of developing countries. For the middle income oil-importers, net private flows accounted for three-fourths of the aggregate current account deficit, while for the low-income countries of Asia and Africa, concessional flows were four-fifths of the combined deficit.

Largely because of differences in the sources used for meeting current account deficits and in the level of dependence on export earnings, the debt service ratios of various developing countries followed very different paths in the years since 1980. For all developing countries, the debt service ratio increased from 13.6 per cent in 1980 to 20.7 per cent in 1982, but for Latin American oil-importers, the ratio exploded — from an already high 33.3 per cent in 1980

to 53.2 per cent in 1982. (See table 4.) The rate of increase in the ratio for the poor African countries was sharper still, while it remained stable for the low-income countries of South Asia and for the middle-income oil-importing countries of East Asia.

#### **IV. The Debt Situation in Low-Income Countries**

For the purpose of this analysis, low-income countries are defined as those with per capita income of less than \$410 in 1981 prices. They include most of the African countries south of the Sahara as well as all of the Asian mainland east of Iran. However, for analytical purposes, it is important to distinguish between sub Saharan Africa and mainland Asia.

Thus while the growth of low-income Asia lagged behind the developing country average in the 1960s — 4.6 per cent per annum in the period 1960-73 as against 6.0 per cent for all developing countries — it showed a considerable increase and resilience in the 1970s and early 1980s. In the period since the first increase in the price of oil, the annual growth rate of low-income Asia is estimated at 5.4 per cent, which is nearly 30 per cent more than the average for the developing countries, estimated at 4.2 per cent.

There was the same kind of change in the trend of export performance. In the period 1965-73, the volume of developing countries' exports increased at an annual rate of 8.2 per cent, but for low income Asia it was much lower, only 7.3 per cent. After 1973, the volume of low-income Asian exports increased at a rate more than twice that of all developing countries — 9.9 per cent as against only 4.2 per cent. This extraordinary performance was made possible in part by greater diversification in the products exported. For the three largest countries of this region, the share of manufactures in total exports exceeded 50 per cent: it was 66 per cent for Bangladesh, 59 per cent for India, and 50 per cent for Pakistan. This was a considerable improvement over the early 1960s, when the share of manufactures was about a third of total exports. A shift in the direction of trade was another contributing factor in the impressive performance of low-income Asian countries: in 1960, the bulk of their exports went to the industrial market countries — 75 per cent for Sri Lanka, 66 per cent for India and 56 per cent for Pakistan and Bangladesh. These proportions declined very significantly between 1960 and 1981, so that by 1981 the share of exports going

to industrial market economies had declined to 58 per cent for India, 42 per cent for Sri Lanka, 36 per cent for Pakistan and 34 per cent for Bangladesh. This was a welcome development, since a significant proportion of exports now went to the oil-exporting countries, whose demand for imports — particularly imports from South Asia — remained robust even during the recession of 1980-82.

In part because of the diversification of exports and in part also because of their direction towards the more robust economies of the Middle East, the South Asian countries did not experience the sharp deterioration in their terms of trade that marked the export performance of the low-income countries of Africa. For the sub-Saharan African countries, rates of growth in GDP and per capita income declined from one period to another. The GDP growth rate declined from 3.5 per cent in 1960-73 to 1.4 per cent in 1973-80, and to 0.5 per cent in 1980-82. And since 1973, the African countries have seen per capita income decline: in 1981 prices, the average per capita income for sub-Saharan Africa was about \$265, but by 1982 this had declined to \$235.

In external trade, the countries of sub-Saharan Africa experienced the same kind of declining trend. In 1965-73, their export volumes increased at an annual rate of 6.7 per cent, but in the seven-year period 1973-80 the rate of increase declined to only 0.3 per cent per annum, while, as already noted above, the volume of exports from the low-income countries of Asia increased by as much as 9.9 per cent per annum. Perhaps the best way to evaluate the problem created by the changes in Africa's external trade environment is to calculate the extent of the deterioration in its export purchasing power. Export purchasing power is a product of two indices: terms of trade and quantum of exports. Changes in the terms of trade for Africa and other groups of countries can be seen in table 2 above. The changes in purchasing power of exports are given in table 5.

Reading tables 2 and 5 together provides a revealing picture of the enormous differences in the situations faced by the low-income countries of Asia and Africa. Poor countries of Africa suffered a terms of trade decline in 1973-76, whereas there was a considerable improvement in the terms of trade of low-income Asia in the 1973-76 period. Terms of trade declined for both regions in the 1979-82 period, but the fall for Africa was 10 percentage points greater than that for low-income Asia. Besides, the increase in the volume

**Table 5: Changes in Purchasing Power of Exports  
(Per cent)**

<u>Countries</u>	<u>1973-76</u>	<u>1979-82</u>
Low-income		
Asia	58.5	15.7
Africa	-18.7	-3.5
Middle-income		
Oil-importers	4.5	2.5
Oil-exporters	71.0	11.5

Source: The World Bank, *World Development Report, 1983* (New York: Oxford University Press, 1983), Table 2.4, p.13.

of exports compensated for the terms of trade decline in the case of Asia, while there was some compensation in sub-Saharan Africa, but not enough to prevent the steady decline of export purchasing power. In 1982, low-income Africa could buy only three-fourths of the volume of imports they could buy in 1973, even with a much larger export volume. This explains in part the different rates of growth in debt outstanding for the two regions. As shown in table 6, low-income Asia's outstanding debt doubled in nominal terms between 1973 and 1982, increasing from \$16 billion to \$38 billion. For low-income Africa, the increase was almost fivefold: from only \$5 billion to as much as \$23 billion.

The difference in the build-up in outstanding debt was not the only difference between the African and Asian situations. There are a number of other reasons why the African situation today is much more precarious than the situation in low-income Asia. For instance, a considerable proportion of South Asian debt was obtained on highly concessional terms. In 1973, 83 per cent of the outstanding debt for this group of countries was on terms that carried a very low rate of interest; between then and 1982, the proportion of concessional element in outstanding debt increased by three percentage points, to reach nearly 86 per cent. In other words, concessional debt outstanding increased by nearly 11 per cent per annum during this period. But there was a slight decline in the ratio of concessional debt to total debt for low-income Africa; from 58 per cent to 55 per cent — which also shows that the Africans were prepared to go to the private markets to maintain the level of imports (see table 6).

**Table 6: Sources of Developing Countries' Debt**  
**(\$ billion)**

**Debt outstanding and disbursed**

	<u>1973</u>	<u>1975</u>	<u>1978</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>
Countries						
Low-income Asia	16	20	28	33	34	38
Low-income Africa	5	8	14	20	22	23
Middle-income	<u>88</u>	<u>134</u>	<u>258</u>	<u>354</u>	<u>409</u>	<u>457</u>
All developing	109	162	300	407	465	518

**Of which from concessional sources**

	<u>1973</u>	<u>1975</u>	<u>1978</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>
Low-income Asia	13	17	25	29	30	32
Low-income Africa	3	4	8	10	11	12
Middle-income	<u>34</u>	<u>45</u>	<u>66</u>	<u>82</u>	<u>90</u>	<u>93</u>
All developing	50	66	99	121	131	137

Source: The World Bank, *World Debt Tables, 1983-84* (Washington, D.C.: The World Bank, 1984).

Because of the structure of South Asian debt, the amount of net transfers has remained high. In 1973, the South Asian share in total net transfers to developing countries was 7 per cent; nine years later, in 1982, the share increased to as much as 43 per cent. For low-income countries of Africa, the trend was in the opposite direction.

In view of their good export performance and their reliance on concessional sources of external borrowing, it is not surprising that the countries of South Asia did not have much of a problem servicing their debts. Of the 59 reschedulings that were undertaken in 1981, 1982 and 1983 — 30 under the aegis of the Paris Club for debt from official sources and 29 involving commercial banks — there was only one case that involved a South Asian country. This was Pakistan, which in 1981 had \$263 million of official debt rescheduled. In other words, of the more than \$75 billion of debt owed to public and private sources that was rescheduled during this period,

**Table 7**  
**Multilateral Debt Renegotiations, 1975,1983**

Country	Number of reschedulings 1975-83	(Millions of U.S. dollars)							
		1975-80		1981		1982		1983 <sup>a/</sup>	
		Paris Club	Commercial bank	Paris Club	Commercial bank	Paris Club	Commercial bank	Paris Club	Commercial bank
Argentina	2		970						(6,000)
Bolivia	2				(444)				(536)
Brazil	2							(3,800)	(9,800)
Central African Rep.	2			55				(13)	
Chile	2	216							(4,100)
Costa Rica	2							(107)	(1,259)
Dominican Republic	1								(660)
Ecuador	2							(200)	(2,150)
Gabon	1	105 <sup>b/</sup>							
Guyana	3		29				14		(24)
Honduras	1								(122)
India	3	436 <sup>c/</sup>							
Jamaica	3		126		103				(166)
Liberia	4	30		25			27	(25)	
Madagascar	3			142		103			(195)
Malawi	3					24		(30) <sup>d/</sup>	(57)
Mexico	2							2,000	(22,550)
Morocco	1							(1,200)	
Nicaragua	3		582		190		(55)		
Niger	1							(29)	
Nigeria	1								(1,830)
Pakistan	1			263 <sup>c/</sup>					
Peru	4	478	821					(450)	(2,320)
Romania	4					(234)	(1,544)	(195)	(572)
Senegal	4			77		84		(81)	(92)
Sierra Leone	2	66							
Sudan	4	373			638	174		550	
Togo	5	170 <sup>c/</sup>	68	(92)				(300)	(84)
Turkey	5	4,696 <sup>c/</sup>	2,640		(3,100)				
Uganda	2			27		(10)			
Uruguay	1								(170)
Yugoslavia	1								(3,800)
Zaire	6	1,594	402	574				(1,600)	
Zambia	1							(320)	
Total	84	8,164	5,638	1,225	4,475	629	1,640	10,900	56,487

Note: Arrangements concluded with commercial banks and official creditors in the same year are regarded as separate reschedulings.

a. Covers arrangements signed, or agreed in principle, through December 1983. Cuba and Poland, which also renegotiated debt-service payments with commercial banks during 1983, are not members of the World Bank and, therefore, are excluded from this table. Panama's debt-restructuring agreement, signed with commercial-bank creditors in September 1983, was a refinancing, rather than a postponement of formal rescheduling of maturities, and also is omitted. Figures indicate rescheduled amounts as reported by the countries or, if in parentheses, as estimated by IMF or World Bank staff.

b. This was an agreement of a special task force.

c. Refers to Aid Consortia Agreements.

d. This was an agreement of a creditor-group meeting.

Source: The World Bank, *World Debt Tables, 1983-84* (Washington, D.C.: The World Bank, 1984), p. xviii.

South Asia's share was only 0.4 per cent. As against this, there were 19 reschedulings for low-income Africa, amounting to a total of over \$4.5 billion. Twelve African countries had their debts rescheduled in this period, which means that several of them had to return to their creditors repeatedly for relief. (See table 7.)

The above analysis of the debt situation in low-income countries reveals a remarkable amount of restraint exercised by the governments of South Asia at a time when commercial loans were easily available. However, conservative financial policies — although important in explaining the South Asian situation — were not the only reason that these countries came out relatively unscathed from this period of great trouble for other parts of the Third World. There were other circumstances which favored South Asia. Two of these — access to concessional flows and a very good export performance — have already been mentioned. The third was South Asia's Middle East connections.

The migration of millions of South Asians to the Middle East in search of jobs and the consequent flow of remittances back to the home countries provided external resources that covered a fairly large proportion of the increase in the value of imports that occurred as a result of the hike in oil prices in 1973 and again in 1979. In 1980, migrants remitted a total of \$3 billion to South Asia (and this is perhaps a very conservative estimate, since a fairly large amount flowed back through unofficial channels). Low-income Africa did not benefit to the same extent. For the countries in that region, remittances sent by the migrants for 1980 are estimated at only \$300 million.

This brings us finally to the point where a number of important questions should be raised about the economic prospects of low income countries: whether these trends can be expected to continue in the future; whether terms of trade for Africa will improve to the extent that its reliance on capital flows for financing imports will decline to some extent; whether South Asia can expect to increase its export earnings at rates more than the average for developing countries; whether remittances from the workers who have migrated to the Middle East will continue to increase; and whether all low income countries will continue to receive concessional flows at past levels. While the future is difficult to predict when it depends upon the political and economic actions of a number of different coun-

tries, it does appear that the economic environment for low-income countries will be less hospitable than it has been in the past. The worsening of the environment has already occurred somewhat and is the result of the political decision taken by several large donors to reduce the quantum of monies available to IDA, the soft window of the World Bank. Up to now, IDA was a significant provider of development finance to low-income countries. With IDA's resources seriously constrained, Asia's share may decline in order to protect flows to sub-Saharan Africa.

According to current estimates, the amount of concessional assistance being provided to developing countries is not likely to increase at the rate of the sixties and seventies. The OECD has estimated that ODA — official development assistance — may increase at the rate of 2.0 per cent to 3.0 per cent in real terms in the remaining years of this decade.<sup>8</sup> This rate will be lower than the rate of increase in the gross domestic product of the OECD countries, which means that ODA as a proportion of GNP of the industrial countries may decline from the already low level of 0.38 to about 0.35 per cent by the end of the 1980s. Also, it appears that more ODA flows will be directed towards sub-Saharan Africa, while the share of the middle-income countries will remain about the same. This would mean a decline in the proportion of ODA going to South Asia.

It also appears that the import elasticity for South Asian products in industrial countries — percentage increase in imports from South Asia for every one percentage point increase in the gross domestic product of industrial countries — is expected to decline. This might happen as a result of the level of "penetration" reached by the more important South Asian exports such as textiles, clothing, garments and leather products. In 1980, the penetration ratio — share of imports in estimated consumption — was on the order of 5.4 per cent for textiles, 16.3 per cent for clothing and footwear and 17.3 per cent for leather products. These are considered to be high levels of penetration which have already caused the United States and some European countries to adopt import-restricting policies. At the same time, in part because of the aging of the populations of industrial countries, consumption of these products may not increase as rapidly as it did in the past. It appears, therefore, that unless South Asia further diversifies its exports, its performance in this area may not equal that of the past.

While the prices of the commodities on which the bulk of African export earnings depend have increased somewhat in recent months, there is not much likelihood of their recovering to the levels that prevailed in the sixties and early seventies. At the same time, food imports have begun to claim a very large proportion of the volume of concessional assistance flowing to Africa. In 1973-81, the volume of African food imports increased at the rate of 14 per cent per annum. By 1981, the value of food imports was equivalent to one-fourth of total concessional flows. If, in the years ahead, sub-Saharan Africa is able to reduce its food import increases by one-half — to 7 per cent between 1984 and 1995 compared to 14 per cent between 1973 and 1981 — even then, the value of these imports would be equal to nearly three-fourths of the likely level of concessional flows by 1995. Since Africa depends on concessional flows for the bulk of its domestic investment, these developments would obviously have a very serious effect on its economic prospects.

Remittances sent by migrant workers — the second important source of foreign exchange for the countries of South Asia and not an insignificant contributor to total resource flows for many African countries — may not increase at past rates. Construction in the Middle East was the largest employer of Asian and African labor, but there has been a considerable slow-down of activity in this sector. There is some fear that a reverse movement of labor may begin. It is feared that politics may cause disruptions in the economies of the Middle East, and that if this happens, not only will there be a decrease in the rate of growth in remittances, but the level of remittances may actually decline.

In sum, the future prospects of low-income countries do not look very hopeful. This is especially true for Africa, but even for low-income Asia external circumstances may be less supportive than in the past. From these facts, the conclusion may be drawn that — whereas the very high levels of debt outstanding for Latin American countries have riveted the world's attention on those countries, sometimes to the neglect of the situation of the world's poor countries — the real intractable development problem exists not in the western hemisphere but in Asia and Africa.

1/ The World Bank, *World Debt Tables, 1983-84* (Washington, D.C.: The World Bank, 1984), p. 1.

2/ W. Arthur Lewis, *Growth and Fluctuations, 1870-1913* (London: Allen and Unwin, 1978).

3/ The World Bank, *World Development Report, 1983* (New York: Oxford University Press, 1983), p. 21.

4/ International Monetary Fund, *Recent Multilateral Debt Restructurings with Official and Bank Creditors*, IMF Occasional Paper No. 25 (Washington, D.C.: IMF, 1983), p. 6.

5/ Larry A. Sjaastad, "International Debt Quagmire — to whom do we owe it?" *World Economy*, September 1983, Vol. 6, pp. 305-324.

6/ IMF, *op. cit.*, pp. 9-14.

7/ *Euromoney*, October 1980, p. 30.

8/ Organization for Economic Cooperation and Development, *Development Cooperation: Efforts and Policies* (Paris: OECD, 1983), pp. 77-78.

## CHAPTER 9

### *Adjustment in East Asia: South Korea & Taiwan*

Gustav Ranis

#### I. Introduction

It is a common lament nowadays that the brilliant post-war era of rapid growth in income and trade — which we had begun to take for granted — ended with the first oil shock in 1973 and that all kinds of calamities have befallen the world, and especially the Third World, ever since. The inventory of problems ranges from lower growth to higher inflation, from lower productivity gains to higher interest rates, and from lower aid levels to higher protectionism. While the South and North complained strenuously about each other's inadequacies in the '50s and '60s, most observers today would be truly ecstatic if we could count on a return to the economic environment of that era. But this is highly unlikely. It is much more likely that the 1950-73 period will someday be seen as an unusually favorable "blip" in the overall experience of our weary globe and that we have returned to an environment which is much less expansionary and as a consequence much less friendly to new comers to the development club.

Adjustment to deterioration of the international environment of the kind we have experienced since 1973 is inevitable. The questions are: How did the adjustment, in fact, take place in different parts of the Third World? What does this imply about the permanence with which the deterioration is viewed? And what can be learned for the exercise of available policy options in the future? This matter takes on major importance especially if the deterioration is not just a temporary aberration.

There are only four fundamental ways in which a developing country can adjust to a worsening of the international situation: (1) it can "tighten its belt" and lower its growth target; (2) it can try to borrow more abroad; (3) it can try to reduce its imports via import substitution; and (4) it can try to increase its exports by

taking a larger share of a shrinking global export volume. Most countries will probably attempt some combination of all of the above, and the different relative weight that countries give to each of these options is both striking and instructive.

The least developed or the really poor countries where most of humanity resides are essentially restricted to some combination of measures 1 and 3. Even in the heyday of the "vent for lending" created by the petrodollar surpluses of the early 1970s, Eurodollar market institutions and commercial banks much preferred the NICs; and those poor countries dependent largely on agriculture and natural resources, faced with recession and staggering terms of trade losses, could do little to prevent large reductions in export earnings — not to speak of increasing them. While the fate of these countries — especially in the context of stagnant or declining aid levels — represents perhaps the most serious adjustment problem on the world's agenda, it is not the subject of this paper. Nor are we here primarily concerned with the majority of the NICs or near NICs, mostly located in Latin America but also found in Asia (e.g., the Philippines, Malaysia, Indonesia) and Africa (e.g., Nigeria, Kenya) whose adjustment efforts have consisted mainly of a combination of options 2 and 3 above. Our focus, instead, is on the minority of NICs located in East Asia, especially South Korea and Taiwan, whose adjustment to the same international deterioration has been mainly to combine options 1 and 4, that is, tightening the belt and expanding exports. There is a general consensus that the East Asians have done better than almost anyone else, and certainly better than the other NICs and near NICs — a result we might not have been led to expect, given their greater exposure to the vagaries of the international business cycle.

It is this situation of doing well in the face of an adverse external environment which makes the East Asian countries especially interesting, for it raises the question of whether their experiences can be duplicated in other countries. Moreover, it raises the following basic questions: If the East Asians have, in fact, done better, is this mainly due to favorite treatment received — in relative terms — from the rest of the world, or to their own actions, i.e., the adjustment options selected and the specific policies deployed in pursuing them? And secondly, if the differential outcome is, in fact, mainly a consequence of their own actions, are these relevant lessons to be learned

which might still be useful today for the other NICs? Section II is devoted to an examination of recent East Asian adjustment experience. Section III presents some brief conclusions of possible relevance for international as well as national policymakers concerned with the overall problems of debt and adjustment in the Third World.

## **II. Adjustment in East Asia**

There can be little doubt that, overall, the East Asian NICs have adjusted well, by any relative standard, to the shocks that emanated from the international system since the mid-1970s. If we compare growth rates of real per capita GDP, which is still considered a good "bottom line" indicator, we may note that in 1974-79, in the wake of the first oil crisis, Taiwan and Korea either maintained or actually increased their growth rates, while those of the other NICs declined somewhat. The contrast is even sharper in the wake of the second oil crisis when, with the exception of Mexico, which had by then become a major oil producer, the other NICs experienced a substantial decline in growth rates while Taiwan certainly maintained a respectable rate of advance. South Korea, for reasons which have to do both with unusual domestic instability, i.e., the Park assassination, and with some economic factors to which we will turn later, did not do quite as well. We will, in fact, find it useful not only to compare East Asians with the other NICs but at the same time to point out differences between South Korea and Taiwan, which are often mistakenly viewed as having had identical policies and identical relative success in adjusting.

If we look at how the attempt to maintain growth rates was generally financed we may note that in all NICs a fairly substantial increase in public and publicly guaranteed debt was registered in the post-1973 period (see table 8) with another much smaller jump apparent in the post-1979 period, when there was a substantial diminution of available OPEC surpluses and when a gradual disenchantment on the part of commercial banks with Third World lending set in. However, given marked differences in the size and the early initial conditions of these countries we really must also turn to a comparison of the export performance and of the increasing debt in relation to that export performance as a way of adjusting to the

Table 1

## Annual Growth Rate of Real Per Capita GDP (%)

	1950-55	1955-60	1960-65	1965-70	1970-74	1974-79	1979-81
Taiwan	5.4*	3.1	6.1	6.5	7.8	7.7	4.2
S. Korea	5.9	0.4	3.6	7.6	7.9	8.3	0.5
Mexico	2.4*	2.7	3.6	3.3	3.2	2.4	6.2
Colombia	2.4	0.5	1.5	3.0	3.7	2.6	-0.4
Philippines	4.5	1.8	2.5	1.8	3.7	4.0	0.9

Notes: Growth rates computed using the compound formula.  
Philippines: growth rates for real per capita GNP.

Source: 1. Taiwan: *Statistical Yearbook of the Republic of China*, 1982, 1980.  
2. \*Computed from *World Tables 1980*.  
3. All others: computed from *IMF International Financial Statistics Yearbook 1982, 1980*.

new post-1973 international conditions. Tables 2 and 3 show that the adjustment policies of the East Asians included trying to increase their share of a relatively endangered total export market.

While the East Asian economies are much smaller than some other NICs, the change of the export orientation ratio from the '50s to the '80s is quite remarkable and has no equivalent among the other NICs (see table 3). When we look a bit more closely, we see that much of this increase in exports is due to manufactured exports (see tables 4 and 5). Moreover, within manufactured exports, as tables 6 and 7 indicate, the consumer non-durable goods exports became increasingly important in the early period and have declined somewhat in more recent years.

A comparison of the annual growth rate of manufactured exports (table 5) and that of consumer non-durable exports (table 7), also indicates the continued emphasis on labor-intensive exports in Taiwan and an earlier shift towards more capital-intensive and durable and consumer exports in Korea. Similarly, as we examine the record of the debt burden (total debt service as a percentage of

Table 2

## Annual Growth Rate of Exports (%)

	1950-55	1955-60	1960-65	1965-70	1970-75	1975-80	1979-81
Taiwan	(51-55) 5.3	12.4	21.3	22.0	15.4	16.3	8.9
S. Korea	(53-55) -12.9	16.4	23.5	33.8	23.7	17.5	13.5
Mexico	5.5*	3.6*	6.5	5.8	2.8	(75-79) 12.0	n.a.
Colombia	(53-55) -4.5	4.9	2.1	4.1	5.9	(75-79) 8.3	n.a.
Philippines	(53-55) 10.6	0.6	11.4	-0.1	2.6	12.3	5.6

- Sources:
1. Taiwan: *Statistical Yearbook of the Republic of China, 1982, 1975.*
  2. \*Computed from *World Tables 1980.*
  3. Philippines: for years 1975-81: computed from *1982 Philippine Statistical Yearbook.*
  4. Korea: for years 1975-81: computed from *1983 Economic Statistics Yearbook (Korea).*
  5. All others: computed from country tables of the *UN Yearbook of National Accounts 1980, 1969.*

exports (table 9)), we note not only the large contrast between the East Asian NICs and the three other NICs represented, but also a much heavier reliance by South Korea relative to Taiwan on the inflow of foreign loans to sustain an acceptable growth rate. Korea stands between Taiwan and the other NICs in terms of its overall performance, and it thus has much to offer by way of instruction, as is also indicated by the relative resort to inflation in order to maintain growth in the face of adverse international conditions. As table 10 demonstrates, inflation rates in the '70s and early '80s in Korea are generally comparable to those of the other NICs, while those of Taiwan are substantially lower.

We may thus draw one general conclusion, i.e., that adjustment emphasizing the capture of an increasing share of new export markets was resorted to by the East Asians, especially in the realm of

**Table 3**  
**Export Orientation Ratio**  
**(Exports/GDP)**

	1950	1955	1960	1965	1970	1975	1977	1979	1980	1981
Taiwan	10.3*	8.2	11.3	18.7	29.7	39.3	49.2	53.9	53.7	53.4
S. Korea	4*	1.8	3.3	8.6	14.3	27.6	34.8	30.0	36.6	39.9
Mexico	17.0	16.7	10.6	9.5	7.7	6.7	10.3	11.2	12.6	11.9
Colombia	10.8	12.0	15.7	11.3	14.2	15.1	17.4	16.2	15.7	11.2
Philippines	13.4	12.7	10.6	17.2	19.1	18.6	19.0	18.8	20.4	19.0

Note: Figures computed from exports and GDP in current prices.

Sources: 1. \*From 1980 World Tables.  
2. Taiwan: *Statistical Yearbook of the Republic of China, 1982, 1978.*  
3. All others: from *IMF International Financial Statistics Yearbook 1983, 1980.*

labor-intensive manufactured exports, in South Korea somewhat less successfully than in Taiwan. The other NICs, on the other hand, resorted much more to foreign borrowing, while trying harder to maintain traditional growth rates.

A full perusal of the tables presented, moreover, demonstrates one other important fact from which perhaps an even more important lesson should be drawn, namely, that many of the differences in performance during the most recent decade have their roots in a substantially different performance during the early post-war period of development. It will, in fact, be our basic working assumption that a differential ability of various NICs in different parts of the world to adjust to the adversity of the most recent decade is very much related to differences in structure which emerged much earlier, differences which were masked by the relatively favorable international environment of that quarter century.

Our argument that differential performance since 1973 is based on decisions taken earlier within the various NICs of the Third World is supported by the fact that, contrary to some people's views, the

**Table 4**  
**Manufactured Exports as a Percentage of  
Total Exports**

	1962	1965	1970	1975	1979	1980	1981
Taiwan	50.46	46.00	78.62	83.65	90.54	90.81	92.25
S. Korea	18.15	52.03	74.91	76.81	81.46	80.09	81.30
Mexico	12.90*	14.12	29.98	29.48	20.05	10.97	8.12**
Colombia	2.85	6.20	7.95	20.06	19.61	19.62	27.24
Philippines	4.62	5.59	6.38	11.60	20.84	20.25	22.80

**Note:** Manufactured exports are defined as SITC codes 5+6+7+8—67—68.

- Sources:**
1. *1983 UNCTAD Handbook of International Trade and Development Statistics*, Table 4.1
  2. \*Computed from *1962 UN Yearbook of International Trade Statistics*.
  3. \*\*Computed from *1981 UN Yearbook of International Trade Statistics*.
  4. 1962 figures computed from the *UN Commodity Trade Statistics, Statistical Series D*.
  5. Taiwan: *1983 Taiwan Statistical Data Book*.

better performance of the East Asian NICs relative to other NICs during the recent decade cannot reasonably be placed at the doorstep of a more favorable or less punitive set of international forces facing them. The same reduction in international demand, the same deterioration of the terms of trade, the same rise in the interest rates since 1979, the same increase in protectionism facing the Latin American and the other Asian NICs — Indonesia, Malaysia, Philippines, etc. — faced the East Asian “Gang of Four.” In fact, we could safely state that the East Asian NICs were considerably more vulnerable to the shocks of that era, given their almost total dependence on imported oil. If anything, it may be said that, due to the initially greater success in exports of the Koreas and Taiwans of the NIC world, the resistance of the rich countries to imports was much more directed towards the East Asians than towards the other NICs. What therefore needs explanation is why the East Asians were able

**Table 5**  
**Annual Growth Rate of Manufactured Exports (%)**

	1962-65	1965-70	1970-74	1974-79	1979-81
Taiwan	23.8	41.7	41.7	22.9	22.1
S. Korea	116.2	43.1	55.8	28.7	19.9
Mexico	8.8	13.7	31.1	4.1*	-1.7*
Colombia	37.6	12.4	59.0	10.1	11.5
Philippines	18.8	13.4	38.5	29.5	15.3

Notes: Growth rates computed with the use of compound formula.  
Manufactured exports are defined as SITC codes 5+6+7+8.

Sources: 1. \*Computed from *1981 UN Yearbook of International Trade Statistics*.  
2. Taiwan: for years after 1970: *1982 Statistical Yearbook of the Republic of China*.  
3. All others: computed from the *UN Commodity Trade Statistics, Statistical Series D* for each year.

to overcome the adversity of the post-1973 period relatively well. This is a task to which we shall now turn, drawing on the differences between Korea, the intermediate case, and Taiwan, perhaps the best case of adjustment, in the process.

While we cannot here attempt a full analysis of the Korean growth path and the policy packages that have been in place since the early 1950s, it is instructive to review quickly that earlier stage in order to understand better her performance in recent years. The period of the 1950s had very similar characteristics in Korea and Taiwan, though admittedly the initial conditions in Taiwan with respect to climate and agricultural infrastructure were somewhat more favorable. As is well known, both countries had an unusually favorable colonial heritage based on Japanese colonial investments and had an early import substitution subphase during which entrepreneurial experience was accumulated and the rural infrastructures was further strengthened through land reform, irrigation investments, etc.

**Table 6**  
**Consumer Nondurable Exports as Percentage of  
Manufactured Exports**

	1965	1970	1975	1980	1981
				(1979)	
Taiwan	37.5	41.2	43.7	33.0	32.6
S. Korea	48.2	49.5	49.6	39.7	39.5
Mexico	14.2	13.5	16.6	15.6*	15.4*
Colombia	46.7	38.0	41.0	44.7	42.5
Philippines	12.1	9.0	16.1	31.2	34.3

**Note:** Consumer nondurables are defined as SITC codes 61+64+65+84+851+892.

**Sources:** 1. \*Includes SITC codes 61 and 64; computed from 1981 *UN Yearbook of International Trade Statistics*.  
 2. Taiwan: for years 1975-81: *The Trade of China, 1975, 1979, 1981 and 1982 Statistical Yearbook of the Republic of China*.  
 3. All others: computed from the *UN Commodity Trade Statistics, Statistical Series D* for each year.

In the 1960s both Korea and Taiwan shifted from import substitution to an export substitution policy mix, with labor-intensive growth in manufactured goods directed towards international markets and a greater market orientation. Such market orientation is not to be confused with laissez-faire; it represents a shift of government policies towards indirect rather than direct controls and a type of intervention which works through the market. This combination of entrepreneurial maturation and policy change led Korea and Taiwan to a very substantial increase in industrial exports, as they were able to use their unskilled labor surplus for the conquest of internationally competitive consumer non-durable goods markets. The policy change included import liberalization, the replacement of multiple exchange rates by unified rates, a major devaluation, interest rate reform, and a change in the treatment of foreign investment, all accompanied by negligible increases in real wages, a capital output ratio below 3 and most rapid increases in the most labor intensive exports.

Table 7

**Annual Growth Rate of Consumer Nondurable  
Exports (%)**

	1962-65	1965-70	1970-74	1974-79	1979-81
			(70-75)	(75-79)	
Taiwan	14.9	44.4	31.9	23.6	20.1
S. Korea	145.1	43.9	51.7	27.0	16.7
Mexico	-5.0	12.5	45.7	-0.2*	-3.8*
Colombia	36.4	7.9	65.0	11.3	6.6
Philippines	12.0	6.9	64.6	43.6	23.1

**Notes:** Growth rates computed with the use of compound formula.  
Consumer nondurables are defined as SITC codes 61+64+65+84+851+892.

**Sources:** 1. Computed from *1981 UN Yearbook of International Trade Statistics*; excludes SITC codes 61 (data not available).  
2. Taiwan: for years after 1970: *The Trade of China* for each respective year.  
3. All others computed from the *UN Commodity Trade Statistics, Statistical Series D* for each year.

By the late '60s and early '70s there was some divergence in policies and performance between the two East Asian NICs. While Taiwan maintained its emphasis on labor-intensive and non-durable consumer goods exports, trying to capture an ever larger share of these markets, South Korea responded to the quadrupling of oil prices in part by accelerating the growth of petro-chemical and other heavy industries, and in part by accepting substantial budget deficits and abandoning the previous high interest rate policy, in order to use the interest rate as a tool for subsidizing preferred industries. As a consequence, fixed investment in Korea doubled between 1975 and 1978, and there was a strong shift to construction projects in the Middle East and to the subsidized exportation of capital intensive goods. At the same time, there was still substantial labor surplus to be absorbed. As a consequence of agricultural neglect, real wages began to rise prematurely, food imports mushroomed, foreign capital inflows assumed large importance, the capital-output ratio rose, and the export composition shifted toward more sophisti-

Table 8

Public/Publicly Guaranteed Debt\*  
(US\$ Billions)

	1972	1974	1976	1978	1979	1980	1981
						(early 1982)	
Taiwan	0.78	1.11	2.23	2.94	3.08	5.50**	
S. Korea	2.89	4.36	6.82	11.36	13.93	16.27	19.96
Mexico	3.92	8.31	15.93	25.62	29.24	33.59	42.64
Colombia	1.63	2.09	2.45	2.77	3.34	4.05	5.08
Philippines	0.88	1.10	2.12	4.21	5.13	6.41	7.39

Note: \*Disbursed only.

Sources: 1. *World Debt Tables 1982-83.*  
 2. Taiwan: *World Debt Tables 1980-79.*  
 3. \*\*From *1983 Annual Supplement of the Quarterly Economic Review of Taiwan* which does not indicate if private non-guaranteed debts are included.

Table 9

Total Debt Service\* as a Percentage of Exports

	1972	1974	1976	1978	1979	1980	1981
						(1982)	
Taiwan	4.5***	3.4	3.9	4.6	4.2	4.0****	
S. Korea	19.4	11.0	10.4	11.3	13.7	12.6	13.7
Mexico**	22.3	18.8	31.1	54.6	62.3	31.8	28.2
Colombia	21.4	21.3	12.6	11.6	15.0	10.9	23.1
Philippines	23.6	12.6	14.6	26.5	23.2	12.5	18.3

Notes: \*For both public and private debt.

\*\*Excludes debt service for private non-guaranteed debt.

\*\*\*Computed using merchandise exports from IMF (IFS) Yearbook 1979.

Sources: 1. *World Debt Tables 1982-83.*  
 2. Taiwan: *World Debt Tables 1980, 1979.*  
 3. \*\*\*\*From *1983 Annual Supplement of the Quarterly Economic Review of Taiwan.*

Table 10

## Annual Rate of Inflation (%)

	1970-71	1973-75	1975-77	1977-79	1979-81
Taiwan	2.9	24.6	4.7	7.7	17.7
S. Korea	12.5	24.8	12.7	16.3	24.9
Mexico	5.1	19.4	22.2	17.8	27.1
Colombia	10.7	23.6	26.5	21.2	27.0
Philippines	12.5	20.2	7.1	13.1	15.5

Note: Computed from CPI using compound formula.

Sources: Data for CPI from:

1. Taiwan: *1982 Statistical Yearbook of the Republic of China*.
2. All others: *IMF International Financial Statistics Yearbook 1983*.

cated watches, optical instruments, metal products, nonmetallic minerals and machinery.

The same period of the '70s was substantially different in Taiwan, with an accelerated expansion of labor-intensive manufactured exports, a greater willingness to let the growth rate slip a bit and, except for one year (1974-75), a resolute policy of maintaining surpluses in the government budget and generally avoiding the sharp inflation experienced in Korea. Monetary expansion was not very restrictive in either country, roughly 30 per cent a year, but the difference in fiscal restraint was marked.

Korea embarked on a secondary import substitution and export effort before her unskilled labor surplus had been fully absorbed and exported. She was ready to use price controls and direct intervention through the subsidization of particular exports in a range of fairly heavy industry at a relatively early stage. Thus, while Korea responded to the multi-fiber agreements in textiles and the quotas in footwear by strong government intervention to encourage the heavy chemical industries in the 1970s, Taiwan was less quick to change her policy stance, maintaining a relatively realistic exchange rate, higher real rates of interest, etc. When importuned to provide

**Table 11**  
**Comparative Export Performance in 1981:**  
**Korea and Taiwan**

		Exports (In Billion Dollars)		Capital-Intensity <sup>3/</sup> (In thousand 1981 \$)		Wage Rate <sup>3/</sup> (In Thousand 1981 \$)	
		Korea	Taiwan	Korea (1981)	Taiwan (1976)	Korea (1981)	Taiwan (1976)
1.	Misc. Manufactures <sup>1/</sup>	1.7	4.3	7.0	5.6	2.7	1.9
2.	Wood Products	0.5	1.2	9.0	6.4	2.6	2.0
3.	Electronic Products	1.8	2.8	5.6	5.3	2.8	2.2
4.	Metal Products	1.1	1.0	8.3	5.8	3.1	2.0
5.	Clothing & Footwear	4.9	4.4	2.3	4.0	2.1	1.8
6.	Textiles, natural <sup>2/</sup>	1.3	1.2	7.9	8.8	2.4	2.0
7.	Textiles, synthetic	1.2	0.9	9.6	29.7	2.5	2.5
8.	Steel Products	1.4	0.4	17.4	10.6	3.6	2.7
9.	Transport Equipment	2.0	0.8	20.6	20.9	4.3	2.4
10.	Rubber Products	0.5	0.2	12.6	7.3	3.7	2.3
11.	Basic Chemicals	0.36	0.3	53.1	55.5	4.7	3.3
12.	Sugar Refining	0.2	0.02	66.1	29.0	5.4	4.6
13.	Fertilizer	0.2	0.0	48.2	64.2	5.8	4.3
14.	Cement	0.34	0.07	69.4	101.2	5.5	5.1
15.	Nonferrous Metal	0.1	0.04	28.6	35.7	3.8	2.8
16.	Iron & Steel	0.4	0.05	75.5	154.0	4.5	3.4
17.	Machinery	0.9	2.2	13.5	11.2	3.3	2.4
18.	Petroleum Products	0.1	0.4	113.1	118.3	8.4	4.3
	All Manufacturing	21.0	22.5	11.7	12.0	3.0	2.2

- Notes:
1. Including nonmetallic mineral products (except cement), precision instruments and plastic products.
  2. Including natural fiber yarn and fabrics and other textile products except synthetic fiber yarns and fabrics.
  3. 1981 prices for Taiwan were obtained by applying the WPI for all commodities (158.42) and WPI for capital goods (143.35) with 1976 base year and the exchange rate of 36.8 NT\$ per dollar. (The exchange rate of 682.7 won per dollar was applied to Korea.)

Source: Korean Traders' Association, *Foreign Trade Statistics*, and Inspectorate General of Customs, *The Trade of China (Taiwan District)*.

favors to special industries or industrialists in response to the international deterioration, the Taiwanese Government was more likely to resort to individual firm-oriented action, avoiding the overall inflation caused in Korea by government deficits and the low interest rate policy.

Since 1979, the policy divergence between Korea and Taiwan has substantially lessened. Korean policymakers apparently realized, even before the second oil shock hit them, that they had better get back on the export substitution track they were on before 1968. They adjusted their policy mix towards a lower growth of the money supply, reformed their credit structure back to a uniform and higher real interest rate, resumed import liberalization and returned to a light industry and export mix. While this policy adjustment was temporarily set back by the second oil shock and the Park assassination of 1979, it was resumed after 1980 in an effort to resume higher growth with price stability. The 1980-86 Fifth Five Year Plan, for example, targets import liberalization to rise from 77 to 90 per cent of imports, a gradual complete withdrawal of non-tariff protection in favor of tariffs, plus a move towards greater uniformity in tariffs followed by a gradual down-phasing. Interest rate differentials have already been reduced, with the intention of letting real rates rise during the period. The targeting of strategic industries for preferential credit and tax treatment is being played down at present. And the exchange rate has become much more flexible. As a consequence of all this, growth rates have increased, inflation has declined, and the debt problem seems to be less serious today than it was at the end of the '70s.

While Korea has thus demonstrated its policy and entrepreneurial flexibility, another consequence of the differential paths followed by the two East Asian NICs during the '70s can be demonstrated with the help of table 11. We note that in 1981, for the labor-intensive non-durable goods categories (items 1-6), as well as for machinery (item 17), Taiwan was a much more important exporter than Korea. With respect to the heavy industries, on the other hand, Korea had relatively larger exports. In addition we notice that in the important labor-intensive sectors, capital intensity was substantially higher in virtually every instance in Korea, while the reverse was true in the case of some quantitatively less important heavy industries. Moreover, as we would expect, wage rates were uniformly lower in Tai-

wan, although this may be as much due to a greater use of unskilled labor relative to skilled labor as to differences in wages by particular categories of skills.

Thus table 11 demonstrates that, in spite of Korea's return to the export substitution policy, the heavy hand of history still dictated a substantial differential in performance between these two East Asian NICs. But what is more important for our purposes is the demonstration that there exists a wide gradation of experience across the developing world and that policy mixes which give rise to different adjustment capacities are neither monolithic nor unalterable over time. In the final section we turn to some of the conclusions that may be drawn from the adjustment experiences outlined here.

### **III. Conclusions for Policy**

It is by now a generally accepted proposition that everyone has to adjust to a less favorable international environment. What is less well agreed upon is how much effort should be expended in trying to improve that environment and how much in attempting to adjust to it. This is a question which cannot be addressed fully in the context of this paper. But it is clear that the deterioration of growth rates in the advanced countries and the advent of higher interest rates and a less plentiful supply of foreign capital are likely to constitute not short-term aberrations, but rather a return to a less favorable long-term trend. The question of what path of adjustment will be chosen by other NICs and near NICs in the years ahead then becomes relevant. In other words, it is not "bad times" which distinguish countries from each other, but their capacity to adjust to the "bad times." Moreover, this capacity to adjust at a particular time is not just a function of today's policy decisions but also a function of the past, i.e., the flexibility acquired and the options made available to a particular society. Taiwan, as we have seen, adopted the most pervasive reforms in interest rates, exchange rates, protection rates, etc. in the early '60s and experienced the lowest rate of inflation and one of the lowest rates of debt accumulation in the developing world.

It is thus no accident that the most severe debt problems have been concentrated among the newly industrializing countries of Latin America while some of the East Asian countries have been in a better position to "muddle through" with a relatively smaller reliance on foreign capital. In large part, as we have seen earlier,

this has to do with differences in the structure generated during the '60s and '70s, i.e., in the extent of export orientation, in the manufactured export share, in the composition of these manufactured exports, and in the consequent differential reliance on capital imports and inflation. The other NICs have tended to rely on their more abundant natural resources, supplemented by foreign commercial loans, to finance a more protected and less flexible development path. The East Asian NICs, in contrast, gradually switched to a greater reliance on the mobilization of their human resources, unskilled and skilled, and their entrepreneurial resources, which meant that they were able to adjust much better, seizing a larger share of the total export pie in the wake of the post-1973 crisis. While much of the rest of the developing world has responded to the recent deterioration by pulling inward even more, the East Asians have not yielded to this third wave of export pessimism.

If this analysis is generally accepted, what are the policy implications for specific action, national and international? On the national front, the adjustment experience of the East Asian NICs seems to indicate that there is nothing as important as creating an entrepreneurial capacity to "roll with the punches." In East Asia, no matter how hard hit the newly expanding export sector has been, by quotas and other kinds of restrictions, there has been a capacity to get around the quotas, shift to new products, export to new markets, and emphasize new specifications. That is, they have been able to fill the many holes in the standard international trade classification (SITC) categories and, as indicated above, gradually shift from an exclusive concentration on advanced country markets to less-developed country markets once their wages began to rise. For example, in 1975 Korea exported only 19 per cent of its manufactured goods to other developing countries; by 1980 the figure was almost 32 per cent. In the case of Taiwan, the figure changed from 23.5 per cent to 34.2 per cent. As long as a labor surplus condition obtains, developed country markets are favored but once that labor surplus is mopped up, a natural orientation towards other markets develops, quite in line with comparative advantage theory.

Certainly no wholesale radical reforms can be expected or desired in other NICs in the midst of what is still a bad recession globally, and certainly no wholesale imitation of developments in the East Asian countries should be undertaken. Every country is

very different, as we have seen even among the East Asian NICs; but at the same time there are many areas of overlap. One can observe a tendency of policy reformers in some NICs to reexamine previous decisions, which were apparently made to try to "skip" the labor-intensive export substitution phase and move directly into secondary import-cum-export substitution activities, in a more sophisticated range of products. What is needed, in my view, is a selective and gradual restructuring of domestic policy in that general direction with a clear maintenance of a policy trend and a clearly demonstrated desire to avoid the stop/go pattern which is so destructive of a system's capacity to adjust.

With respect to the international community, I believe a change is needed in the international funding and organizational instrumentalities that are currently in place to help NICs negotiate longer term adjustment packages. Improved methods of maintaining the capital flow and reviewing policies are required. Moreover, a more distanced relationship from some of the most powerful donor agencies is needed to generate the requisite freshness and intellectual independence, as well as capture the attention of policymakers in both rich and poor countries. The debate as it is now commonly posed is whether there should be increased liquidity, desired by the NICs, or more austerity, as desired by the international community led by the IMF. In my view the question instead should be the appropriate use of temporarily larger levels of liquidity to effect longer term structural change, once it is agreed upon by the recipient country. There is a large spectrum of international creditors and donors, running from commercial to investment banks to bilateral donors, multilateral donors, the IMF and the World Bank, all dealing with the same individual NICs and all presumably with the same interest in improving their adjustment capacity, and not simply in paying lip service to reform. Foreign capital can make it possible to avoid reform as well as be very helpful in making reform possible, if there is prior agreement at the technical and political level by all the parties concerned. In fact, conditionality can only work if there is such general agreement all around on the merits of any restructuring package. All too often, what we have instead is a combination of cynicism, friction and failure in many developing countries.

What is needed ideally is to place the entire discussion of adjust-

ment capacity and the roles of foreign capital and conditionally on a different plane, less confrontational, more long-term and more multilateral. All parties involved must discuss the prospects and the actions required, in a non-paternalistic and multilateral setting. Of course, improving the international environment would help, and there is no implication here that we should not continue to work very hard in that direction. But the centerpiece of our debate should not be about more or less liquidity, but about how we can better administer a larger volume of liquidity in line with an assured change in structure on the part of individual developing countries.

Meaningful policy change takes time and resources, both to provide policymakers with long-term reassurance before any action is taken and to protect groups that might be negatively affected. Recognition of the long-term nature of the problem and of the long term requirement for capital inflows is an essential prerequisite for the resumption of growth in much of the Third World, which is bound to benefit both the rich and poor countries. Import liberalization in the context of a wholesale reduction of imports is much more difficult than import liberalization linked to temporarily increased levels of capital inflows as part of a fundamental restructuring of the entire system. Conditionality requires full agreement on the domestic policy package appropriate to each country and full credibility with respect to the international mechanism used to arrive at it and to ensure it is adhered to by all the parties. If long-term real structural adjustments are not achieved in some such fashion, the current debt renegotiation will only be buying time, without a real purpose, and will serve only to postpone action on the basic crisis.

## *A Comment*

**Carlos G. Langoni**

The financial markets are still closed to the majority of developing countries. Normal market forces have been replaced by negotiated lending with extremely high transaction costs. Commercial banks do not know how to solve the problems of de facto frozen assets and nonperforming loans or how to explain to their shareholders how this happened. Regulators and monetary authorities send mixed signals and do not know whether to stick to past rules, move toward more rigid regulations or simply surrender to reality and try, informally, to accommodate the situation.

Unless we dramatically change the current strategy for dealing with the debt problem, we may very soon see a political overreaction by the LDCs — the inevitable refusal to accept a clearly regressive pattern of adjustment, one that offers no clear way out of the present crisis. What we need is a symmetrical adjustment process in which the financial system and, possibly, the industrialized countries as a group would have to bear some of the costs side by side with the developing nations.

First, the banks need to recognize their co-responsibility in the indebtedness process. Overborrowing and overlending are different sides of the same coin. Some losses will have to be internalized: depending on the write-off criteria, this could be spread over time so as not to have any serious destabilizing effect on the financial system as a whole.

Curiously enough, the greatest opportunity for reducing future capital losses which may arise out of unilateral action by the LDCs lies precisely in adjusting the pricing of rescheduling to more realistic levels. There is no logical reason for applying market terms to a patently nonmarket situation. One interesting idea is to use a long term expected (and fixed) real rate of interest in the renegotiations instead of current short-term rates. This would still keep a market reference but would be more consistent with the capacity of the LDCs to service debt, while at the same time minimizing the impact of interest rate fluctuations.

Furthermore, with International Monetary Fund collateral, margins after rescheduling should be lower than before. There has

been a greater recognition that renegotiated spreads should be more reflective of transaction costs than an arbitrary evaluation of risks that cannot be taken seriously after a default or de facto transformation of short-term debt into long-term debt.

Besides an important reduction in base rates and spreads, some sort of capitalization of interest payments may still be necessary to make the present debt negotiations feasible. Brazil is a classic example. If LIBOR were to increase on average by just one percentage point the additional resources needed to achieve Brazil's present current account target would be about \$700 million.

But we may find that the losses implicit in the differential between current and expected real rates may be too high to be absorbed entirely by the banks. There may be no alternative but to look for official support, either at the individual country level or via a multilateral institution. In the end, creation of an "interest facility" may be necessary to assure the implementation of the new debt-adjustment program. The costs of such a program would be clearly offset by the benefits associated with the reduction of uncertainties in financial markets. And the plan would open the way to a new path of adjustment with growth.

This eventual official participation may be further justified by extending the principle of co-responsibility to industrialized country governments as well. In general, they took a favorable position on the recycling role of the banks, which replaced bilateral actions of the past, indeed, many governments competed for the creation of new world financial centers.

All of those governments believed in the efficiency and automatism of the international money market, and none of them anticipated its failure. Now that this has happened, however, someone will have to pay the price. The U.S. has a special responsibility here because of the direct relationship between its fiscal and monetary policies and the behavior of external real rates of interest, whose unprecedented high levels over the last five years have added to the debt problems of the LDCs.

The interdependence among the major parties involved is so strong that we need a formal institutional framework in which these negotiations may be held in a more coordinated fashion. One simple idea is an expanded Paris Club that would deal not only with government debts but also with private debts, which represent the major portion of the overall LDC external debt. Under this umbrella we

could gather IMF officials, private bankers, and representatives from industrialized country and LDC governments in addition to monetary authorities.

This new framework is essential in order to upgrade the relative bargaining power of the LDCs at the negotiating table. Their position has been fundamentally affected by the fact that, as a direct corollary of the liquidity crisis itself, the LDCs have no international reserves. This new forum would also help establish common and more unified action among governments, regulatory agencies and monetary authorities, whose conflicting views have been one of the more disturbing elements in the present world crisis.

Finally, a word about the performance of the IMF in the present crisis and what we should expect from this institution in the near future. The IMF is clearly suffering from the contradictions between the new role that needs to be performed and its internal philosophy. It has had to adopt an interventionist posture — contrary to its market dogmas — in order to assure the assembly of the minimal financial resources consistent with the balance-of-payment targets implicit in its cosponsored adjustment programs. This is an innovative and important role which, in a certain way, has helped to close a dangerous gap of leadership left by the major industrialized country governments' absence from this role. Nevertheless, for this action by the IMF to be coherent, it must go beyond the quantitative details of the financial packages and look into the fundamental issues of the pricing of rescheduling. Since no one understands better than the IMF the vulnerability of a country's cash flow projections to interest variation, and since halfway intervention is like halfway pregnancy, there is no reason why the IMF should not participate in bringing pressure upon the banks about the interest rate issue.

The Fund has found more difficulty in designing adjustment programs which are internally consistent and at the same time allow for social and political constraints. In Latin America, all but the Mexican programs had to be revised after a few months of implementation. Overambitious goals and too short periods of adjustment have created a credibility gap which feeds negative expectations and makes the implementation of the policies still more difficult. In the Brazilian case, the Fund underestimated the lags between monetary and fiscal policies and their final impact on prices in a context of

generalized indexation. Furthermore, the Fund did not take into consideration that a feasible or optimum path for elimination of the public deficit must be related to a reasonable rate of reduction of current expenditures. The setting of a zero target for the deficit for 1984 has led to a sharp increase of taxation of private profits and savings, diminishing the potential for private capital accumulation which, by the way, has been one of the implicit long-run objectives of the Fund program. There are still many unsettled issues, such as those related to the coexistence of nominal performance criteria and compulsory indexation which characterizes the Brazilian economy. Finally, the Fund did not show great political sensitivity towards Brazil's delicate process of redemocratization when it openly raised the sensitive issue of a specific wage policy as a precondition for the approval of the stabilization program. As we have learned since, in an open political system such as Brazil's at present, wage policy will necessarily be the outcome of political negotiations and not of a unilateral technocratic formula.

Of course, few persons would dispute that adjustment to new external constraints and correction of internal imbalances are badly needed by the LDCs. But it is also important to recognize that, given the structural nature of the problems, what is required is a sustainable adjustment process, not a transitory one. When we talk about sustainability we must explicitly take into account not only economic factors but also social and political restrictions. Time is a key element for a successful readaptation of the LDCs. Let us recall that it took at least 10 years for Brazil to undergo a structural transformation as a response to the oil crisis. How long then will it take to implement the fundamental changes that will allow a resumption of growth with a much lower access to external finance? This is a very difficult question to answer, but the compounding effects of the oil and interest crises mean that adjustment hardly will be completed within the 3 year period pre-fixed in the present IMF program. The Fund must accept this reality and begin to design longer and more flexible programs.

The Brazilian experience dramatically illustrates all the different dimensions, economic as well as human, of the present debt crisis. Here we have a country with tremendous natural resources, large investment opportunities and vast managerial capacity whose dynamism has been its past trademark, paralyzed by a financial crisis

whose causes and consequences are beyond its own sphere of influence. No country in the world can accept passively a condemnation to stagnation, particularly when growth is needed to open up the channels of social mobility.

It is clear from the foregoing analysis that an adjustment process characterized chiefly by the control of inflation and the steady reduction of the current account deficit will not — under the present rules of renegotiation — lead to a new path of growth for the LDCs. The simultaneous adjustment of the financial system itself will also be needed. This will not happen spontaneously but, on the contrary, will require concerted action by governments and multilateral institutions. This broader adjustment is essential for the preservation of the recently-grown infant market economies in many developing countries. Further delay in finding a new strategy to deal with the debt situation and the financial needs of the LDCs will certainly lead to political radicalization in these countries and to a renewed trend of economic isolationism.

The debt crisis has shown clearly how the international financial flows have integrated the world. What happens in Rio de Janeiro, Buenos Aires, or Mexico City is now having a profound impact in New York City and Wall Street. Let us learn this important lesson and work together in finding common solutions geared toward the economic and social welfare of the whole world.

**PART IV**

**CONDITIONALITY**

**AND THE ROLE OF THE IMF**

“While the legitimacy of Fund conditionality extends to ensuring a consistent and plausible set of policy changes, there is no legitimacy — if legitimacy is restricted to requirements imposed to ensure repayment — in selecting a unique set of policy changes.”

— Frances Stewart



## CHAPTER 10

### *An Overview\**

Shahid J. Burki

Adjustment and conditionality are not easy subjects to deal with; they comprise not only the basic economic questions relating to the process of adjustment but also some very pertinent political issues. However, introduction of these pertinent political concerns can cloud the main issues. If a discussion between two economists yields three opinions and if a dialogue between two political scientists or politicians lead to the articulation of four different views, then total confusion can prevail when economists — both academic and those dealing with matters of policy — venture into the political field. Nonetheless, the politics of economic decision-making is something with which all economists should become fully conversant.

While analysis of conditionality has often centered around a discussion of the Fund's programs, the subject has a much larger scope. As such, it is legitimate to expand the scope of discussions and to include the roles played by many other actors in the global economic system as well.

The workshop discussions on adjustment and conditionality focused on three issues in particular:

*One*, what are the problems with the international financial system as it is working today?

*Second*, what is the precise way in which an ideal financial system, free of political, economic and institutional frictions, should work in today's circumstances?

*Third*, how do we proceed from the present conditions to such an ideal system?

As might be expected, the workshop showed virtual consensus on the diagnosis of the present situation. But there were many more answers to the second question of how the system should function,

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*\* Based on the rapporteur's report, papers, presentations, and discussions in the workshop on this topic.*

and still more to the question of how the system should proceed from where it is today to where it should be tomorrow and the day after.

## **I. Some Troubling Aspects of the Present Situation**

The present situation is marked by a large debt overhang — some \$810 billion, of which \$150 billion is short-term — but with declining levels of commitments, disbursements, net flows and net transfers. Last year, for instance, there was a net flow of \$21 billion out of the major debtor countries to public and private creditors, an amount equivalent to 2 per cent of the combined GNP of these countries. The change was dramatic, since in 1981 there was a positive transfer of \$17 billion to the major borrowers. While commercial banks are not in the business of making positive transfers to the developing countries over the long-run, a drastic switch from positive to negative flows over such a short period of time is indeed very disruptive. The situation might have been worse if the Fund had not intervened so decisively; but, as one of the participants commented, “the Fund’s efforts carry their own limitations: the world financial system cannot work for long on the basis of ‘involuntary’ capital flows, and spontaneous flows can be generated only if debtor countries are perceived to be pursuing adjustment programs that give assurance of a return to external viability in a medium-term context.”

It was suggested that the Fund is not only in the business of fulfilling the repayment condition for itself and other lenders (some of whom are involuntarily associated with it), but has also assumed a grandmotherly role in relation to borrowers — a role which many question severely. It was argued by some participants that the Fund’s new adjustment program applies “mechanically” the same system of performance evaluation used under traditional stand-by arrangements. But it was pointed out that several Fund programs of recent years point to increased differentiation, and that the impression of mechanistic behavior may be created by the way the Fund monitors its programs. However, there was agreement that though the Fund should not cease to perform this grandmotherly function, it should do so less sternly and with greater compassion.

## II. Definition of an Ideal System

After highlighting the problems the international community presently faces, the workshop began the task of defining the ideal system in which there would exist solutions to all these problems. Such an ideal would consist of a reformed and expanded International Monetary Fund; expanded multilateral banks with abundant resources available to lend on highly concessional terms; commercial banks that would be more sensitive to the long-term impact of the actions they take with respect to lending to developing countries; and developed countries that would bear in mind the consequences of their economic decisions for developing countries.

Some particular aspects of an ideal system for adjustment are the following:

(1) The Fund should assign an unambiguous meaning to the term "adjustment" and to the term "conditionality". There is considerable ambiguity in the way these terms are currently defined, with the result that the programs agreed by the countries with the Fund often contain conditions not strictly relevant to the adjustment being sought.

(2) An ideal system would also provide time for adjustment — a period of time that could be negotiated between the various parties involved in bringing about adjustment. Adjustment takes time: sometimes because of supply inelasticities (a point that was raised in connection with the analysis of the debt situation in sub Saharan Africa), and sometimes because of the very complex system of state enterprises, which cannot be redesigned overnight.

(3) Some participants reiterated the finding of the Istanbul Roundtable (summer 1983) that the process of adjustment can hurt the more vulnerable groups who are seldom part of the political systems in the borrowing countries — but who should occupy a prominent place in the conscience of the Fund in particular and of the international community in general. But it was also recognized that misguided policies have been adopted in the past in the name of equity. This was one of the principal themes of the World Bank's *World Development Report, 1983* which pointed out that policies adopted to protect vulnerable groups often did more damage to them and to the economy in general. For instance, state intervention in wage determination almost always resulted in added inflationary pressures and reduced growth.

(4) Adjustment in an ideal system, therefore, will be seen not only as an economic or a financial process but also as one that is political. Adjustment gone wrong can send politicians packing — as has happened in several countries. In the more extreme case, adjustment gone awry can produce “the equilibrium of the graveyard.”

(5) In an ideal system, deficit countries would have access to larger amounts of institutionally provided liquidity, perhaps by creation of a significant amount of SDRs.

The discussion of the other constituent parts of the ideal system — multilateral banks, commercial banks and developed countries — can be summarized quickly:

*First*, a more intensive effort must be made to substitute private sources with multilateral sources of finance. After the addition to global liquidity that resulted from the increase in oil prices in the 1970s, commercial banks played a very important role in financing balance-of-payments deficits of developing countries. But there is a need to return to the pre-1973 situation, in which public sources had dominance in meeting the resource gap of the developing countries. Private banks, suppliers of export credit and private direct investment will now play at best only a marginal role in meeting the resource needs of the poor countries. Additional funding efforts will be needed, including supplementary resources for IDA, additional capital for IBRD and the regional banks, and additional resources for such specialized agencies as IFAD.

*Second*, the commercial banks need to adopt new practices. There is perhaps a need for them to: (i) capitalize interest within the framework of rescheduling negotiations, and (ii) include in the rescheduling an automatic flow of new funds which would compensate for any eventual increase in the rate of interest.

*Third*, developed nations have to be cognizant of the way their policies affect the course of events in the developing world. The Fund's Articles of Agreement underscore the need for adjustment in all groups of countries, developed and developing, debtor and creditor, exporting and importing. Several speakers referred to situations in which action or lack of action by industrialized countries had jeopardized adjustment in developing countries. For instance, the accumulation of public deficits has long since ceased to be a characteristic of the underdeveloped alone and has become common among the developed nations, with obvious repercussions in the developing countries; and wide fluctuations in the value of the major

international currencies have further complicated the task of developing countries. It was suggested that developed countries also need to pursue the policies of IMF conditionality.

### **III. How to Usher in the New Ideal System**

The new system — consisting of a reformed but expanded Fund, a highly capitalized system of multilateral banks, chastened behavior by the commercial banks, and more sensitivity on the part of developed countries — will take time to be born. How do we hasten this process? Who is to play the role of midwife?

A number of suggestions were made:

(1) The participants assigned the Fund several tasks. These included guiding the commercial banks towards what were regarded as rational practices in the given circumstances, preserving low conditionality lending when imbalances occur for reasons beyond the control of the borrower, leading the way towards the development of "joint conditionality," and creating more institutional liquidity through an issuance of SDRs. However, some participants rejected the midwife's role for the Fund. The Fund, they said, will never have enough resources to play this role; they found the idea of commercial borrowing politically infeasible for the Fund; and, given the recent experience with the legislative process in the United States, they did not see much point in asking for a very large review of quotas once again. In light of this, it was suggested by some that the central banks of industrialized countries could perhaps play such a role.

(2) Some participants suggested politicians as the midwives for bringing forth the new system. The politicians in the debtor countries would have to convince governments in the creditor nations to give the Fund resource flexibility. The politicians in the debtor countries would have to decide about the distributional impact of adjustment policies. An intergovernmental organization such as the Fund is too clumsy to be entrusted the delicate task of a midwife. However, it is not clear whether such a responsibility would be accepted by politicians.

(3) Perhaps the midwife's role can be played by the international organizations working together, or by using a forum such as the Development Committee, which has representation from governments as well as institutions.

## CHAPTER 11

### *Fund Conditionality: A View from Inside\**

Azizali F. Mohammed

#### Introduction

The subject of IMF conditionality has attracted a great deal of attention in the past few years, both in the context of international monetary reform discussions and as an issue in itself. Starting from the Arusha initiative<sup>1</sup> of 1980, the debate has been conducted in many different forums, including the G-77, the Non-Aligned Conference, UNCTAD, etc. Of special note are papers emerging from a conference organized by the Institute of International Economics, Washington, D.C. in 1981,<sup>2</sup> the work of the Commonwealth Study Group<sup>3</sup> in 1982-83, and a major research project of the Overseas Development Institute (London), published in 1984.<sup>4</sup> Apart from these, a large outpouring of articles and scholarly monographs has covered everything from a discussion of general principles to the results of Fund programs in individual countries<sup>5</sup> and regions.<sup>6</sup> The Fund itself has contributed to the growing literature through speeches by its Managing Director, pamphlets, seminar volumes, and cross-sectional analyses of country programs and other staff publications.<sup>7</sup> Not included in this listing is the large volume of public commentary that has accompanied the recent debates over enlargement of Fund resources and its role in dealing with problems of external debt of a number of developing countries.

While the constraints that operate on member countries undertaking stabilization programs are well enough known, there is perhaps less appreciation of the difficulties that confront the Fund itself in negotiating adjustment programs. By elucidating some of these constraints, it may be possible to afford to those outside the institution some insights into the negotiating process as it is perceived by those within it.

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\* *The opinions expressed are those of the author and do not necessarily reflect the view of the IMF or its staff.*

### **Clarification of the Concept of Conditionality**

Before turning to the main subject, it would be useful to clarify three points. First, some definitions: Fund conditionality refers to the linking of Fund financial assistance to the adoption of corrective measures by a member country in order to achieve a viable balance-of-payments position such as will allow repayment to be made within a medium-term time-scale. The policies required to bring about this result depend on both the nature and size of the existing and prospective balance-of-payments deficits. Purchases in the first credit tranche, which may be appropriate when the payments deficit is relatively small, require that the member demonstrate reasonable efforts to overcome its problems. Purchases in the upper tranches, which are generally made under a stand-by or an extended arrangements,<sup>8</sup> require that policies be adopted which give substantial assurance that a viable payments position will be reached within a predetermined period.

The literature now broadly accepts that adjustment measures are required in all cases where problems are not of a strictly transitory character. It is less clearly agreed that the need for adjustment measures and, hence, for Fund conditionality, is equally pressing when the problems arise from circumstances largely outside the control of the country. Given the revolving character of the Fund's resources, it is required to make a distinction between temporary and reversible and nonreversible causes. Even where it is possible (and this is not always the case) to draw a clear line between exogenous and domestic causes of balance-of-payments problems, a failure to recognize that the problems are not transitory and self correcting itself becomes an argument for treating the subsequent difficulties as the consequence of domestic policy.

Secondly, there is a recognition that adjustment will always involve costs in the sense of reducing net domestic absorption, and that these are unavoidable costs if the need for adjustment is imposed by a shortage of foreign exchange resources. The basic question is how to minimize the costs, and the debate relates to the content of corrective measures proposed and an evaluation of whether alternative measures could achieve a given balance-of-payments outcome at a lower cost.<sup>9</sup>

Thirdly, some of the academic comment tends to confuse the

content of conditionality with its form. There is a great deal of discussion of performance criteria, review clauses, and phasing: these, however, constitute a framework which the Fund and members have found useful for the purpose of monitoring programs in the course of implementation. The use of fairly uniform monitoring criteria creates the faulty impression that the prescription is standardized. Fund support is provided on the basis of a whole package of macroeconomic and financial measures, much of which is not subject to performance criteria. Such a package may place emphasis on augmenting supply, restraining demand, shifting resources from the nontradables to the tradables sector, or on a combination of all three. However, for monitoring purposes, attention is directed to certain key economic variables that are readily available and relatively dependable.<sup>10</sup> These variables are formulated so as to be consistent with the entire composite of economic and financial policies as well as with anticipated macroeconomic developments over the period. Deviations from the projected levels of these variables are therefore viewed as an indicator that certain elements of the program may not be evolving as anticipated and that it would be necessary to review the economic policy package before moving forward. It is therefore not correct to conclude — based on the observation that most performance criteria apply to variables measuring demand — that the programs supported by the Fund are necessarily oriented wholly towards demand restraint.

The invariable use of credit ceiling as performance criteria also creates the impression that the Fund is a “monetarist” institution. Since the prime focus of every program supported by the Fund is a certain outcome in the overall balance-of-payments as measured by changes in the net foreign assets of the monetary authorities, attention to the domestic monetary counterpart of movements in net foreign assets is only logical. Of course, much more is involved here than a balance sheet identity. There are assumptions that (1) the change in net foreign assets will be positive (i.e., the balance-of-payments will improve) to the extent that the change in broad money exceeds the change in domestic credit and (2) that changes in the demand for broad money stand in a stable relationship to changes in real income, price level, etc. However, the assumption of a stable demand-for-money function is only a starting point for evaluation. Since data on monetary and credit variables are among the earliest

to become available and are also among the most reliable, it is reasonable to treat them as a first approximation check on performance. If they deviate substantially from their projected path, it is a signal that the program might be veering off track. Furthermore, the use of real sector variables — such as domestic absorption or output or investment — to measure performance directly is not possible in most countries, due to lack of timely data on these variables. And these are in any event target variables rather than instrument variables within the policy control of the authorities. It is important to bear these qualifications in mind, because confining attention to performance criteria detracts from the total policy package in support of which Fund assistance is provided.

### **Timing Constraints**

The Fund maintains a policy dialogue with all its members through Article IV consultation discussions. These are normally conducted for all the larger countries (both industrialized and developing) on a 12-month cycle and cover the entire range of macroeconomic policies that bear upon these countries' balance of-payments and exchange rates. There is also a regular flow of periodic information from members to the Fund. The Fund staff will therefore have fairly clear ideas of the financial situation of a country and may even have cautioned it on matters within the Fund's purview where this is appropriate. However, the Fund has no power of initiative to offer financial assistance. The timing of an approach to the Fund is always a decision of the member country. The Fund's own experience indicates that an early adoption of corrective measures is helpful in producing a satisfactory outcome without resort to drastic measures. When action is delayed, the confidence of the country's own asset holders and lenders erodes. Commercial banks may begin to shorten maturities and reduce exposures. The Fund can be called in at any point from incipient unease to the onset of an acute financial crisis. Clearly, the action that is recommended by the Fund will correspond to the seriousness of the situation that confronts the authorities. Some policy options that might be open when an early approach is made (e.g., when the country has reserves) are no longer available at a later stage (e.g., when it is accumulating payments arrears). A Fund mission is usually dispatched within a short time, and its first objec-

tive is to reach an understanding of the situation on the ground and to develop a shared diagnosis. The next step is to devise measures that will ensure that the balance-of-payments situation is contained and then turned around; here the initial conditions that prevail become a prime determinant of the policy prescription.

### **Foreign Exchange Constraint**

What needs to be done and the time in which to do it (i.e., the pace of adjustment) depend critically on an assessment of the resources available to the country, both in the form of foreign savings (including use of Fund resources) and the potential for raising domestic productivity and saving. It has been argued by those who emphasize the structural character of the difficulties of many developing countries that a Fund-supported program should only address the sources of the problem and recognize that in most cases these are only tackled over the medium-term. However, the introduction of policies that will address the problem over the medium-term may not be sufficient in the short-term to eliminate the imbalance, which cannot be financed and would therefore require additional measures to be taken. To state the same idea in a different way, while it is indeed desirable to consider a wide range of alternatives to address the underlying balance-of-payments problem, one cannot escape the fundamental short-term constraint of matching claims on resources with the resources that are available.

The resource constraint applies not only to the speed of adjustment and the choice of instruments but also the manner of their use. It is suggested, for instance, that gradual realignment of the exchange rate to a realistic level might well be the most cost-effective solution in certain circumstances. However, there might be a pressing need to make an immediate, once-and-for-all change in the exchange rate, in the absence of which, leads and lags may continue to operate against a currency, and those who have earlier switched from domestic to foreign currency assets may hold back from repatriating them.<sup>11</sup> In such a case, the discussion of "shock-treatment" versus "gradualist" approaches to adjustment in the literature might well be moot, because the lack of foreign exchange reserves leaves no room for gradualism.

The Fund can and does help to reduce the financial constraint by providing its own resources and by serving to unlock access to other external sources. The Fund's own contribution may be marginal in quantitative terms if the access of the member is constrained by the size of its quota relative to the magnitude of the external imbalance and also by the previous use of Fund resources by the country. Under the current policy of enlarged access, the ability of the Fund to provide resources towards the upper limits of access also depends upon the strength of the program being adopted. The Fund may wish to hold back from a maximum commitment in order to have some margin for influencing both the borrowing country and its creditors over a lengthy period of time. This is true especially where it is judged that debtor countries must depend heavily on commercial and official lenders and on new financing over a number of years to secure debt relief. This also applies to countries that depend substantially on official aid.

Where such reliance is involved, the negotiating process becomes highly complex. It may require several iterations as the content of the program is continually adjusted to the changing estimates of available resources. Even so, the possibilities of error in forecasting remain, and a great deal of time is necessarily spent in obtaining the best possible "fit" of the amounts and terms of external commitments, predicting the path of disbursements, and working out the sharing of burdens among various suppliers of funds. Whether the eventual outcome is more restrictive or less restrictive than needed depends on the accuracy of the projections. Where the projections turn out to be unduly conservative, the outcome will be regarded as the consequence of an unduly restrictive program; on the other hand, errors of optimism can end in loss of confidence for both the country and its foreign partners. In practice, there appears to be a systematic tendency for estimates of foreign exchange availability made by other sources to be unduly optimistic.

### **Domestic Policy Constraints**

As the balance-of-payments recovery path is determined in the light of the projected availability of foreign capital (and Fund resources), the policy package is formulated so as to produce a level and composition of domestic demand, as well as a level and com-

position of domestic demand, as well as a level and distribution of output between tradables and nontradables, such as will tend to produce the desired outcome.<sup>12</sup> Essentially, three sets of measures can be brought into play: (a) aggregate demand management, (b) demand and output switching and (c) strengthening supply incentives and management.

(a) It is axiomatic that corresponding to the external financial imbalance will be an imbalance in domestic finances. The imbalance will not necessarily be of domestic origin, but any improvement in the external balance will necessitate corresponding changes in the domestic financial balance of the economy. If the external imbalance were to be suppressed through quantitative import restrictions and exchange controls, its domestic counterpart would translate into higher inflation or a growing scarcity of essential inputs where prices are controlled and supplies rationed. The causes of imbalance are a mixture of external and domestic factors,<sup>13</sup> and the symptoms of imbalance will be declining foreign exchange reserves and/or accumulating payments arrears as well as rising inflationary pressures. In any case, an improvement in the domestic financial balance will require a careful assessment of the scope for mobilizing resources through the banking system. As a first step, an estimate of the margin for domestic credit expansion will be calculated according to the net foreign assets target and the demand-for-money function.<sup>14</sup>

Where the budget is running a deficit that is being financed or accommodated in part through the banking system, a reduction in the fiscal deficit may be required to free up resources (including financial) for other sectors. Where state enterprises are a significant component of the productive sector, the margin for domestic credit expansion will typically be allocated three ways, i.e., for the budget proper, for state enterprises, and for the private sector. These allocations and the manner in which they are accomplished will be determined by the institutional arrangements in the country. Even where domestic financial markets are well-developed, quantitative ceilings on credit to various sectors may be called for, in some cases with interest rates reflecting the available flow of credit to each sector.

The private sector is often a significant claimant of credit allocations, and its degree of access is again for the authorities of the country to determine. Since Fund negotiations are conducted only with the public authorities, it appears at times that the Fund favors

the private sector. This is because the argument on the size of the public sector deficit to be financed by the banking system tends to be couched in terms of leaving enough resources for the productive sectors not only to maintain their operations but to take advantage of the incentives that become available as a result of changes in the key prices that are the second major element of any adjustment program.

(b) The exchange rate is the key price that must be brought into play if demand switching is to be accomplished in favor of the external sector. Much is made of low supply elasticities in developing countries and the restraints on export markets. There is no great merit in the argument even when the analysis starts, as it does in most academic literature, from an assumed position of equilibrium. This is rarely the case in most situation dealt with by the Fund. The overvaluation of the exchange rate is among the most frequent accompaniments of balance-of-payments difficulty, and depreciation becomes unavoidable if a rational pricing structure is to be established. The fundamental choice that countries have to make is between quantitative allocations and rationing through the price mechanism. The pervasive inefficiencies that accumulate when the former method is pursued in order to maintain an artificial price for foreign exchange become a major impediment to the growth process. The Fund's predilection for exchange rate adjustments is often little more than an effort to correct an existing situation of overvaluation and thereafter to help keep the exchange rate moving in a way that maintains the competitiveness of export industry and the profitability of import substitution.

The prices that primary producers receive for exports are largely a function of the exchange rate, since, being "price-takers," they have little influence on the foreign currency price of their exports. The prices that can be paid to domestic producers are kept lower by an overvalued exchange rate and inflict heavy losses.<sup>15</sup> Similarly, where food prices are controlled, an overvalued exchange rate permits food imports (often obtained through various aid channels) to be sold at prices that make the production of domestic food-grains unprofitable. In the typical case, a persistent overvaluation has either reduced the output of exports or has forced a part into illegal channels. Thus, supply responses can be quite rapid since they involve either a redirection of output into legal channels or a reinstatement of productive capacity that has been abandoned

because producers were bearing losses.

The constraint on using the exchange rate instrument in order to raise domestic output in ways that improve the balance-of-payments is then the pressure from those who benefit from the continuation of existing exchange rate arrangements. An exchange rate action becomes a highly charged political decision precisely because it produces changes in the distribution of income between producers (or potential producers) of foreign exchange and consumers of foreign exchange. Often the impact of exchange rate action on poor urban consumers can be dampened through devices such as subsidies targeted to the poorer elements of urban society. The Fund has been far more willing to accept such transitional arrangements especially if they are offered openly, through the budget. But there are strict practical limits to the effectiveness of such arrangements, and when allowed to persist for any length of time, they become a serious drain on the availability of scarce budgetary resources for development purposes.<sup>16</sup>

A more difficult constraint on the use of the exchange rate operates in countries with pervasive indexation arrangements or where trade unions are strong enough to protect the living standards of their members through industrial action. In such cases, a change in the nominal exchange rate may be quickly offset by corresponding changes in nominal wage rates, leaving the real exchange rate largely unchanged. Changes in indexation mechanisms and other elements of income policy must be introduced if the distribution between tradable and nontradable sectors is to be influenced by a change in the nominal exchange rate. It is important to note, however, that in the short-run any conclusion that a real exchange rate change is not feasible will necessarily place a larger burden of the adjustment on demand restraint and consequently on growth.

The exchange rate instrument is also constrained in member countries operating centrally planned economies. The relationship between the domestic price level and international prices is typically intermediated through specialized foreign trade and banking institutions that intervene between the enterprise sector and the international market. A complex web of subsidies and taxes results in a multiplicity of effective exchange rates. The experience of Yugoslavia for a number of years, and of Romania and Hungary more recently, has resulted in a certain movement in favor of simplifying the exchange rate arrangements so as to allow international price

relationships to bear rather more directly on the allocation of domestic resources. As the need to integrate into the world price structure becomes more pressing, it may be possible to establish a greater role for the exchange rate as an unambiguous link with the outside world even in the more centralized planning systems. In its absence, Fund programs must seek other instrumentalities to produce commensurate results.

Next to exchange rates, interest rates are perhaps the most pervasive in their effects. If interest rates remain for extended periods lower than those prevailing in outside money markets, it becomes impossible to encourage the mobilization of domestic savings or to discourage productive investment. There are often strong domestic resistances (economic, ideological, and religious) to moving towards appropriate interest rates and these become a powerful constraint on the application of monetary policy.

(c) While supply responses to changes in producer prices can and do have a significant role in many instances, there are certainly situations, especially in the poorer countries, where investments in infrastructure and equipment are needed for price incentives to produce substantial results. Change in the quality and composition of public investment are usually required. Such supply-oriented structural adjustment measures may appear to be outside the 1 to 3 year planning horizon of stand-by and extended arrangements. However, they do not necessarily fall outside the 3 to 5 year repayment period for stand-by arrangements or the 3 to 10 year repayment period for extended arrangements. The Fund's expertise in reaching the requisite technical judgements in these areas is limited, and the Fund has sought to rely on its sister institution, the World Bank, for making evaluations of the way in which public investment programs can best fit adjustment purposes.

Another element in a number of stabilization programs is the improvement in the productivity of resources that comes from raising the efficiency of management. Price incentives or budget controls are not easily applied in situations where parastatals control important sectors of the economy and are run inefficiently. While Fund-supported programs will at times focus on particular enterprises that generate large deficits requiring finance from the central authorities, the upgrading of management is often promoted by the World Bank in connection with its project and sector loans. The

Fund itself is willing to provide experts in the central banking and fiscal areas, but their effectiveness — as that of all technical assistance — depends on the authorities' willingness to heed outside advice and on the administrative environment, which may or may not be conducive to permitting expatriate operative to make a "hands on" contribution to management.

### **Fund Constraints**

The preceding sections have cited certain general considerations constraining the formulation and implementation of "conditionality packages" in member countries. It is useful to bear in mind the boundaries of Fund discretion that derive from its purposes, its policies, and its own financing possibilities. Reference to the Fund's Articles should not ordinarily be necessary at this stage of the Fund's history of administering its conditional facilities. It is curious nonetheless that citations of the Articles are made as if the membership has grown negligent of them and its decisions have somehow diverged from them. The adjustment policies that the Fund can support must ensure their temporary use as laid out in Article I(v) and Article V, Section 3(a).<sup>17</sup> Too much emphasis on the lending function of the Fund detracts from attention to its other purposes and from the fact that its resources are available in order to promote these purposes. The mandate to facilitate the expansion of international trade,<sup>18</sup> to maintain orderly exchange rate arrangements among members, and to assist in the elimination of exchange restrictions require that the Fund take these matters specifically into account when considering the use of its resources. To imply that the Fund should only be concerned with repayment without regard to the purposes for which the funds are being provided in the first place is to ignore the Fund's own proper constraints.

Adherence to the Fund's Articles must be reinforced with an understanding of their application through a series of decisions of the Executive Board, starting with the 1952 decision which settled once and for all the principle of conditionality in the use of Fund resources. A milestone in this activity is the decision setting forth the guidelines on conditionality adopted in 1979 and reaffirmed as recently as November 1983.<sup>19</sup> There is a potential conflict between Guideline 4, which stipulates that in devising adjustment

programs "the Fund will pay due regard to the domestic social and political objectives, the economic priorities, and the circumstances of members, including the causes of their balance-of-payments problems" and Guideline 8, which requires that the application of policies relating to the use of Fund resources maintain the "non-discriminatory treatment of members." The staff must operate within this tension. Indeed, it must operate so as to produce comparable conditions for countries that are comparably placed. A great deal of misperception about differences in the degree of severity of programs reflects, as noted earlier, the differences in initial conditions at the time that countries approach the Fund and also differences in the external environment in which the adjustment effort must be carried out.

The environment has undoubtedly grown much harsher during the 1970s than it was in the 1960s (the sharp rise in the price of energy and a slowing down of growth in the industrialized world being only two elements), and it has been even more difficult in the first years of the current decade, with a world recession of great severity, a shift from negative interest rates to positive real rates and a complete change in lenders' perceptions of the creditworthiness of a number of developing countries.

The Fund membership has responded to these adversities with a series of adaptations, starting with the Oil Facilities of 1974 and 1975, which provided relatively low-conditional financing to meet the increased cost of oil imports in those years. The establishment of the Extended Fund Facility in 1974, to provide assistance in larger amounts relative to quota, also took into account the need for a longer time both to implement structural adjustments and to accomplish repayment, lengthening the repayment period from the normal 3 to 5 years, first to 8 and then to 10 years. The Trust Fund, created out of the proceeds of the sale of 25 million ounces of Fund gold, disbursed US \$4.6 billion between 1976 and 1981, of which US \$1.3 billion was distributed directly to 104 developing countries and the rest was lent on highly concessional terms to poorer member countries. Two Subsidy Accounts were established in 1975 and 1980 to reduce the burden of interest cost for poor countries on amounts borrowed by the Fund and re-lent to them. A facility to compensate for the excessive rise in the cost of cereal imports due to circumstances largely outside the control of members was grafted onto

the Compensatory Financing Facility in 1981.

Access to the Fund's resources has been enlarged through successive increases in quotas in 1978 (32.5 per cent), in 1980 (50 per cent), and in 1983 (47.5 per cent). The Supplementary Financing Facility became operational in 1979 and more than doubled the quota limit on access by using borrowed resources. It was replaced by the enlarged access policy in 1981 which raised by a multiple the annual and cumulative limits on access relative to quota. Following the increase of quota at the end of 1983, these limits were reduced in percentage terms, but the new limits of 102/125 per cent annually and cumulative limits of 408/500 per cent of quota (not of scheduled repurchases) have protected the absolute access of members states. The enlargement of access in recent years has been reflected in a substantial rise in disbursements, from SDR 4.6 billion in 1980 to over SDR 7 billion in each of 1981 and 1982 and to SDR 12.6 billion in 1983, almost exclusively for developing countries.<sup>20</sup> At the end of that year, there were undisbursed commitments under existing stand-by and extended arrangements of another SDR 10 billion, which are likely to be disbursed this and next year, in addition to substantial new programs.

These large disbursements have not prevented criticism that the Fund should have been willing to supply even larger sums in view of the difficult external environment. The willingness of the membership to support enlarged access relative to quota has been precisely in response to the adverse external situation. While the need for a longer period of adjustment is open to argument, this means finding ever larger amounts to lend. There are serious constraints on the Fund's ability to borrow these amounts, following the latest increase in quotas, the enlargement of the General Arrangements to Borrow and the likely conclusion of another SDR 6 billion in new borrowing on top of the SDR 17 billion already contracted for. The difficult passage of quota legislation in the largest member country and the unwillingness of the membership to permit the Fund to approach private capital markets point towards a financial constraint that might well become more severe as time passes. This will in any case happen at the country level due to the accumulating use of Fund resources. Where continuous and prolonged use of Fund resources has occurred over a number of years, the Fund's net contribution will perforce be tapering off. The Fund has sought to prevent these tightening constraints on countries, by playing the role of a catalyst,

making its own disbursements conditional on the provision of very much larger sums by other lenders, whether in the form of rescheduling, refinancing, or the commitment of new funds. This effort carries its own limitations: the world financial system cannot work for long on the basis of "involuntary" capital flows, and spontaneous flows can be generated only if debtor countries are perceived to be pursuing adjustment programs that assure a return to external viability in the medium-term. The Fund seeks to help member countries design and support such programs. The implication in some of the academic literature that these programs are simply "imposed" upon member countries shows a total misunderstanding of how the negotiating process works in practice and of the constraints under which it must operate. Moreover, a fundamental lesson of experience is that programs cannot be "imposed." To be useful, a program must be carried out, often in conditions that require courage and stamina. For that, the national officials who carry it out must genuinely believe in the course of action being taken. Hence, real consensus, not the confrontation implied in the world "imposed," is what is essential.

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1/ "The International Monetary System and the New International Order," *Development Dialogue*, No. 2 (1980).

2/ John Williamson, ed., *IMF Conditionality*, Institute for International Economics (Washington, D.C., 1983).

3/ *Towards a New Bretton Woods*, Report by Commonwealth Study Group (London: Commonwealth Secretariat, 1983).

4/ Tony Killick, ed., *The Quest for Economic Stabilisation: The IMF and the Third World*, Overseas Development Institute (London: Heinemann Educational Books, 1984).

5/ Karen Bernstein, "The United Kingdom and the IMF" (doctoral dissertation, Stanford University, 1983). A number of case-studies are to be found in the works cited in footnotes 2 and 4 above. See also *World Development*, Vol. 8 (November 1980).

6/ G.K. Helleiner, *The IMF and Africa in the 1980s*, Princeton University Essays in International Finance, No. 149 (Princeton, New Jersey: Princeton University Press, 1983).

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—, *The Extent of IMF Involvement in Economic Policy Making*, The AMEX Bank Review Special Papers, No. 7 (September 1983).

8/ In recent years, purchases within the first credit tranche, not in themselves numerous, have generally been made as part of, or in conjunction with, stand-by or extended arrangements.

9/ A recent review of the twenty-seven stand-by and extended arrangements approved in 1981 indicates that approximately one third of cases fell into each category.

10/ Guideline No. 9 of the Guidelines on Conditionality states, *inter alia*, that "performance criteria will be limited to those that are necessary to evaluate implementation of the program with a view to ensuring the achievement of its objectives. Performance criteria will normally be confined to (i) macro-economic variables and (ii) those necessary to implement specific provisions of the Articles or policies adopted under them." (Decision No. 6056 (79/83), March 2, 1979, cited in *Selected Decisions of the International Monetary Fund and Selected Documents*, Tenth Issue, April 10, 1983).

11/ This is a far more widespread problem than is generally recognized. Private capital flows have become important in developing countries like Egypt, Pakistan, Portugal, Turkey and Yugoslavia, which rely heavily on workers' remittances. "Their payments positions are highly responsive to expected exchange rate developments and to real interest rates" (Richard N. Cooper in *IMF Conditionality*, Chapter 22, *op. cit.*).

12/ Changes in the distribution of income will ensue as policy changes are implemented, and these are very much for the authorities to evaluate in the way they deploy the various policy instruments.

13/ During the 1970s, there was a combination of factors at work, as brought out by Khan and Knight in "Determinants of the Current Account Balance," *op. cit.*

14/This is also a first step in the sense that monetary projections remain subject to considerable margins of error, given that they are derived from forecasts of changes in real output, in domestic prices, and in the income velocity of the monetary variable selected, as well as from assumed levels of interest and exchange rates. "If the programmed credit ceilings are observed, the departures from the implicit balance-of-payments target will be of necessity equal to the difference between the projected and the actual change in the pertinent monetary variable, and if the projection were reasonable it is as likely that the balance-of-payments outcome will exceed the target as is a shortfall from target." (E. Walter Robichek, *The IMF's Conditionality Re-Examined*," in *Adjustment, Conditionality, and International Financing*, edited by Joaquin Muns, forthcoming in 1984.)

15/Losses also result from inefficiency of management where parastatal marketing organizations are involved, and frequently the only alternative to a larger exchange rate adjustment is an improvement in the competence of their management.

16/"It can be argued that even in critical areas such as those related to income distribution the policies that are generally desirable from the point of view of economic efficiency tend to be the ones that provide the most likely assurance of improving income distribution. Many balance-of-payments recovery programs involve an improvement in the terms of trade for the rural sector which is universally the poorest sector of a country's population." (C. David Finch, *IMF Conditionality*, Chapter 4, *op. cit.*)

17/The text is as follows:

"Article I(v) To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance-of-payments without resorting to measures destructive of national or international prosperity."

"Article V, Sec. 3(a) The Fund shall adopt policies on the use of its general resources, including policies on stand-by or similar arrangements, and may adopt special policies for special balance-of-payments problems, that will assist members to solve their balance-of-payments problems in a manner consistent with the provisions of this Agreement and that will establish adequate safeguards for the temporary use of the general resources of the Fund."

18/ It is to be noted that Article I(ii) states that one of the purposes of the Fund is "to facilitate the expansion and balanced growth of international trade, *and to contribute thereby* to the promotion and maintenance of high levels of employment and income . . ." The language is laying out a strategy for the membership to adopt for achieving certain objectives, rather than requiring the Fund to address the objectives directly.

19/ Other decisions of the Fund having a bearing on the evolution of Fund conditionality are those relating to foreign borrowing (August 1979), the Extended Fund Facility (September 1974, as amended), the Supplementary Financing Facility (March 1980, as amended), and the Policy on Enlarged Access (March 1981). See *Selected Decisions* of the IMF, Tenth Issue (April 1983).

20/ These are exclusive of reserve tranche drawings which are not treated as use of Fund credit. Such drawings were an additional SDR 1.3 billion in 1982 and SDR 1.5 billion in 1983.

## CHAPTER 12

### *Alternative Conditionality*

Frances Stewart

The term "conditionality" describes the policy conditions prescribed by the IMF, which borrowing countries have to fulfill if they are to secure access to those of the Fund's resources characterized as "high conditionality" funds. This paper considers the justification, desirability and possibility of Third World countries developing *alternative conditionality* both for negotiation with the Fund and for borrowing from other financial institutions that exist or might be developed.

Fund conditionality is becoming increasingly important for three reasons. First, the growing difficulties in borrowing commercially have caused an increasing number of countries to have recourse to the Fund. About one-third of developing countries are either negotiating with the Fund or are using Fund resources. Secondly, there has been a marked increase in the proportion of use of high conditionality facilities. Whereas in 1973 about two-thirds of Fund lending was on a low-conditionality basis, by 1980-81 about 75 per cent of new lending involved high-conditionality. Hence the nature of conditionality has become of greater significance. Thirdly, the private sector has come increasingly to wait for agreement on Fund programs before going ahead with its own lending (including roll-over of existing loans). Thus while the Fund accounts for only a small proportion of total balance-of-payments financing (in 1982, use of Fund credit and short-term borrowing by monetary authorities from other monetary authorities accounted for \$6 billion out of a total current account deficit among non-oil developing countries of \$97 billion), its influence over other sources of finance is very large. This is illustrated in the case of Yugoslavia:

Western banks and governments . . . are counting to a large extent on Yugoslavia's reaching terms with the IMF on a new stand-by accord, before they commit themselves for 1984. Mr. Dragan [Vice-Premier in charge of the economy] has admitted that IMF backing 'is very important for the treatment of Yugoslavia by international capital markets and creditors', as well as

providing the Government . . . with support against its critics. (*Financial Times*, December 5, 1983)

Fund conditionality is often viewed from two extreme positions: on the one hand, the Fund and others see conditionality as legitimate and necessary, and the particular conditions imposed as being virtually the only conditions possible to secure the necessary improvement in countries' economic performance (see, e.g., Guitian). At the other extreme, the legitimacy of conditionality as such seems to be questioned by some LDCs, and some famous battles have ensued, as for example with Manley's Jamaica and with Nyerere and Tanzania. There have also been intermediate positions taken. Sidney Dell has criticized Fund conditionality for failing to take into account the source of balance-of-payments problems and emphasizing demand restraint as a cure even where it is quite apparent that the main source of the problems does not lie with excessive domestic expenditure. A study by the Overseas Development Institute has criticized features of the Fund programs and has suggested some reforms, placing particular emphasis on developing programs which minimize the costs of adjustment.

For the most part, however, an all-or-nothing attitude has been adopted by the major actors: the Fund has shown little flexibility with regard to conditionality, while countries have tended either to accept the package as a whole, or adamantly to reject it while failing to suggest an alternative package. Where there has been some significant negotiation, as for example with some of the larger countries recently, it has been generally within a framework set by the Fund. In general there has been little serious debate about the nature of conditionality between countries and the Fund; where agreement has been reached it has been on Fund terms and reflecting Fund philosophy. That this is so is not entirely the responsibility of the Fund. Because of the all-or-nothing approach taken by many countries, in many cases the countries themselves have not made serious attempts to present alternatives and to negotiate on them.

The all-or-nothing approach taken by both sides has had a number of serious adverse consequences. First, quite a few countries have failed to reach any agreement over a prolonged period of time and have thus been left in the limbo of permanent crisis, operating on a hand-to-mouth basis for foreign exchange, with adverse consequences for long-run development as well as political stability. Ghana's history over much of the last twenty years provides one example

of this; Tanzania's recent history another. The recent coup in Nigeria has in part been attributed to prolonged negotiation with the Fund. (See *The Guardian*, January 2, 1984, "Monetary experts argued yesterday that Nigeria's failure to reach a loan agreement with the International Monetary Fund was almost certainly a factor in the military's decision to remove President Shagari from office.") Secondly, many countries have reached an agreement with the Fund, but have then been unable (or unwilling) to execute the programs, so that Fund finance has been withdrawn. In the year to April 1982, Fund loans were cut off because of failure to meet agreed performance targets in over one-quarter of agreed loans. Countries involved included Romania, Zaire, Morocco, Bangladesh, Zambia, Costa Rica, Tanzania, Guyana, Madagascar, Senegal, Uganda, Honduras, and Grenada. (*Financial Times*, April 20, 1982.) This group of countries also has faced prolonged crisis of both an economic and a political nature, with bad effects on long-run development. Thirdly, in quite a few cases where Fund programs have been agreed upon and executed, serious political problems have followed. This has been the case in Egypt, in Sri Lanka and in the Sudan, for example. Fourthly, the programs themselves — reflecting Fund philosophy, and with little input from the countries — have not been developmentally oriented, with a strong deflationary component. This will be discussed more below.

Many of the political and economic problems associated with negotiations over Fund programs arise, in my view, from the rigid attitudes taken by both sides: on the part of some countries, it is the view that any conditionality represents an infringement of sovereignty, and hence attempts are rarely made to present alternative conditions (the Indian negotiations and the recent negotiations with Brazil may be exceptions); on the part of the Fund, there is the view that its package represents the only acceptable adjustment package. If Third World countries sought alternative conditionality, more in line with their philosophy, objectives and individual circumstances, then many political problems might be avoided, and more development-oriented adjustment might occur. But to develop such alternative conditionality requires countries to accept, in principle, the legitimacy of some conditionality. And for the Fund to accept alternative conditionality requires it to recognize the boundaries within which conditionality is justified. The next section will discuss these issues.

## Legitimacy of Conditionality

All lenders make certain demands of borrowers; they may require sureties for the loans they make; the loans involve interest and repayment schedules and are associated with various provisions which come into effect if the borrowers default. For many lending transactions — national or international — the lenders are not in a position to impose any general policy requirements, nor are the borrowers (which are often private firms or individual parastatals) in a position to form policy at a national level. Banks lending to particular enterprises may well suggest, or even require, certain changes in the management of the enterprise so as to increase the likelihood of prompt repayment. Lending, as distinct from giving, takes place with the expectation of repayment plus servicing, and hence the development of conditions associated with the lending is a legitimate aspect of such transactions. But in commercial transactions, conditions are confined to those elements which are directly relevant to repayment.

IMF lending differs from commercial lending in three respects. First, the lending is to governments, not to commercial entities, and hence government policies are a legitimate area for negotiation in determining the conditions associated with loans. Secondly, governments only approach the Fund when they are in overall difficulties (which may be more or less acute, but are never totally absent). Hence it is likely (though not always the case, depending on the source of difficulties and prognostication in the absence of policy change) that some policy change is necessary to eliminate the difficulties, as well as access to Fund resources. Only if the difficulties are clearly of a temporary nature due to factors outside the country's control, and ones which are likely to be reversed, is *no* policy change likely to be the appropriate response.

It follows from these two factors that the Fund's position in lending to governments in financial difficulties justifies some policy conditionality in a way that differs from most lenders. The third respect in which the Fund differs from other lenders is that it is not simply concerned with ensuring policy changes which would bring about a particular improvement in the balance-of-payments, and hence permit the fulfilment of the servicing and repayment condition\*, but also it uses its unique lending position to impose

a particular set of policies on borrowing countries, which it believes is good for them: this is what Sidney Dell has described as the "grandmotherly" function.

This discussion suggests that some policy conditionality is justified (or legitimate) to bring about policy changes which make it likely that the repayment condition is met. Normally there are, as we shall discuss further below, a number of ways in which this might come about. While the legitimacy of Fund conditionality extends to ensuring a consistent and plausible set of policy changes, there is no legitimacy — if legitimacy is restricted to requirements imposed to ensure repayment — in selecting a unique set of policy changes. Viewing the Fund as a lending institution, then, the legitimacy of Fund conditionality covers the repayment function, but not the grandmotherly function.

It may be argued that the Articles of Agreement of the Fund extend its functions (and legitimacy) beyond those of an ordinary lending institution, thus justifying the grandmotherly function. The Articles of Agreement could of course be changed. But taking them as they stand, they are open to a wide variety of interpretations when it comes to selecting particular policy packages. It would, I believe, be impossible logically to derive a unique set of policy changes from the Articles, and very difficult to argue that actual Fund conditionality represents a "truer" interpretation of the Articles than many other policy packages. Article 1 of the Articles is appended to this paper. It is worth making two points about the provisions of this Article. First, for proper fulfillment of these obligations, the Fund must be able to influence the policies of all countries, especially dominant industrial countries. This is particularly the case for provisions (ii) ("facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income"), (iii) ("exchange stability. . ."), (iv) ("multilateral system of payments . . . and the elimination of foreign exchange restrictions"), and (vi) ("to shorten the duration and lessen the degree of disequilibrium in the international balance-of-payments of members"). Using its powers over borrowing countries *alone* to fulfill its obligations (e.g., for reduction of trade restrictions) is a case of trying to meet first-best conditions in a small part of a second-best world. The net effect may be to place excessive burdens on borrowing countries (who generally can least afford it) and to

bring about a worse situation, from a global point of view, than would alternative policies which take the second-best aspects fully into account.

Secondly, there are potential inconsistencies in the Articles of Agreement in a second-best world; for example, there may be conflicts between the objectives of sustaining employment, income and trade, and the obligation to dismantle exchange and trade restrictions, especially in the short-run and in the context of world deflation. These potential inconsistencies permit differences in emphasis and interpretation of the various provisions. Hence the likelihood that a number of policy packages may be equally consistent with the Articles.

The Articles of Agreement, therefore, by no means justify the Fund's rather rigid interpretation of its grandmotherly function. In the rest of this paper we assume that legitimacy is confined to meeting the repayment condition. In devising alternatives, countries may need to pay some regard to the Articles, but this is not likely to restrict the alternatives much, given the second-best issue and the variety of possible interpretations of the Articles.

If the idea of alternative conditionality is to be fruitfully pursued, both the Fund and borrowing countries need to accept three general propositions:

- first, that a lending institution may legitimately require policy changes to meet the repayment condition — i.e., some conditionality is legitimate (legitimacy);
- secondly, that in most situations there are different packages possible which would meet the repayment condition (alternatives);
- thirdly, that any satisfactory set of policies must be jointly worked out by the lender and borrower, not simply imposed by the lender (joint development).

The last proposition is justified on three grounds: first, it should ensure that the country's objectives and philosophy are taken into account in forming the package; secondly, it should make it more likely that the conditions will be adhered to, which is important in view of the large number which are abandoned soon after negotiation; thirdly, it may introduce some political realism into the program, and thus avoid some of the political problems that have been associated with Fund programs.

The first proposition — legitimacy — is always accepted by the Fund, but is often rejected by Third World countries, conditionality being seen as an aspect of *force majeure*, rather than a necessary feature of lending to governments in crisis. It is vital that this should be accepted by Third World governments if alternatives are to be devised; this is also necessary for the successful operation of any Third World bank. The second proposition — the alternatives thesis — seems to be rejected almost entirely by the Fund. The Fund has been strengthened in the rejection of the possibility of alternatives by the fact that very few governments have actually put forward coherent and convincing alternatives. This proposition then needs to be accepted by all parties. The third proposition — joint development — would probably get token assent from both Fund and governments, but the actual process by which programs are devised does not suggest that joint development of a genuine sort often occurs.

The view put forward here about the desirability of alternative conditionality rests on two assumptions: first, that alternative conditionality is possible; secondly, that it would be preferred by some countries, in some circumstances. The bases of these assumptions are discussed in the following sections of the paper.

### Is there an Alternative Conditionality?

Abstracting from short-term monetary movements, the underlying balance-of-payments position of a country may be thought of as consisting of three elements: the visible trade balance, the balance on the invisibles account and net long-term capital movements. That is,

$$B = (Ex - Imp) + Inv_n + C_n.$$

Improvements in this balance may be brought about by a change in any of the three elements (each of which may be negative or positive). The first, the trade balance, may be improved by increasing exports or reducing imports or some combination. The invisibles balance depends on obligations incurred on past debt and direct investment, on payments for other invisibles, such as consultants, insurance and so on, and earnings from such activities as tourism and migrants' remittances. The long-term capital inflow depends on the general outlook for investment and the particular incentives provided to foreign capital.

It is apparent from this very brief account that there are a number of ways of improving the underlying balance, while different elements in the total may be emphasized. Moreover, a variety of instruments may be used to affect the elements in the basic equation. For example, exports may be increased by improving supply conditions (e.g., improving the transport network), or by increased incentive to export (e.g., by devaluation or export subsidies). Imports may be reduced by a general reduction in demand, by increasing the relative price of imports, by improving the supply of import substitutes, by quantitative restrictions on imports, or by some combination of these policies. There are also alternative policies with respect to the other elements in the basic balance. The extent to which the various alternatives really are alternatives depends on the particular circumstances: for example, if full employment prevails (or some other capacity limitation), the options are more limited. But in most realistic scenarios, alternative instruments are possible.

It follows from this very simple analysis that there exist alternative policy packages which would improve the basic balance in most circumstances. Hence it is incorrect to assume that any one set of policy prescriptions is uniquely possible, whether that set be proposed by the Fund or by any other body.

### **Fund Conditionality**

Fund conditionality differs between countries and has changed over time. Nonetheless, there are sufficient common elements for the concept of Fund conditionality to have considerable descriptive connotation.

Fund programs contain three elements: preconditions, performance criteria and other policy elements. (See Bird.) Detailed investigations of these three elements (not always possible for preconditions as they are rarely published) show emphasis on demand restraint, especially through control of government expenditure; credit control is almost invariably a major target and the main performance criterion; policies that are favored include changes in various key prices (exchange rate, interest rate, price policy of parastatals), reduction of consumer subsidies, dismantling of controls and outlawing of multiple currency practices.

For example, one Fund study (Reichman) of 21 programs during 1973-75 found that all 21 laid down credit ceilings; exchange rate devaluation was involved in 10 cases; 10 contained trade liberalization clauses; 16 had clauses to prevent an increase in external debt; and 16 had clauses about government pricing policies. A study of the 1969-78 period showed similar provisions (Beveridge and Kelly), but with some increase in certain conditions during the period: for example, clauses on domestic credit creation and/or budget balance were contained in around 60 per cent in 1969, rising to 95 per cent by 1978; required reductions in government expenditure rose from 10 to 47 per cent; price policy for public enterprises from 5 to 75 per cent; and a reduction in consumer subsidies from 0 to 60 per cent. Towards the end of the 1970s, supply came to be acknowledged as an important aspect of adjustment. Supply policies were interpreted as consisting of policies towards prices and incentives, and were generally added to, rather than substituted for, demand conditions. (See Killick and Sutton.)

The nature of Fund conditionality derives from three elements: the objectives of the Fund programs, the philosophy of the Fund, in particular its view of economic causation, and the desire to institute programs which are readily monitored.

According to Guitian, the objectives of the Fund are "to help members to attain, over the medium-term, a viable balance-of-payments position in a context of reasonable price and exchange rate stability, a sustainable level and growth rate of economic activity, and a liberal system of multilateral payments." The philosophy of the Fund is broadly, although not rigidly, monetarist. Control of domestic credit supposedly secures the twin objectives of inflation control and improvement in the balance-of-payments (although strictly speaking the same instrument cannot attain both). Moreover, along with other monetarist views, it is believed that "the prevalence of inflation and balance-of-payments deficits, which are often associated with relatively high levels of economic activity . . . soon lead to low rates of employment and growth." (Guitian, p. 5.) Consequently, while it might appear that the heavily deflationary policies would act against the declared objective of sustained growth, the reverse is claimed: they are necessary to permit sustained growth.

The use of domestic credit creation as a performance criterion

has the advantage of easy monitoring — too easy in a way, hence the high rate of breakdown of Fund programs. To avoid a breakdown in Turkey recently, the Fund appears to have had to turn a blind eye to “window dressing” of money supply figures, illustrating the point that there are disadvantages in having rigid and easily monitored criteria. (See *Financial Times*, December 23, 1983.)

### Why Alternative Conditionality may be Desired

Alternative conditionality may be desired because countries have different objectives from those espoused by the Fund, or because they have a different philosophy, leading to a different view of causality and a different value placed on various instruments of policy. In fact objectives, instruments and philosophy are often intertwined in logic as well as practice, but it is helpful to try to discuss them separately.

*Objectives:* Improvement in the medium-term balance-of-payments is a necessary aspect of any conditionality in the present context. However, the precise timing of the desired improvement may vary. Many countries would prefer a longer time perspective to that offered by the Fund. For some, the tight time perspective imposed necessitates severe measures, which may work in the short run, but may impede long-term adjustment. The Fund is to some extent constrained in its time perspective by its nature and constitution. Some relaxation of this constraint is necessary to meet countries' perspective on timing. It seems likely, however, that the Fund could take a longer time perspective even within the existing constraints. Some relaxation of the Fund's own financial constraints should permit it to have a less risk-averse attitude in determining timing.

In addition to the question of timing, there are differences in the weight placed on various shared objectives: for example, countries tend to place greater weight on sustaining income and employment, and less weight on inflation control and “orderly” exchange rates. Moreover, countries may have social objectives — e.g., with respect to meeting basic needs — which affect the desired distribution of the burden of adjustment among various social groups. These differences in objectives are likely to have major implications for the preferred adjustment package. Greater emphasis on sustaining output

and employment means that expansionary adjustment is preferred to deflationary adjustment — viz. adjustment through expanded supply of exports and imports substitutes, expansion of invisible earnings and improvements in the medium-term capital account. Greater emphasis on social objectives means preference for policies which protect those most in need, especially programs of health, education, sanitation and nutrition, directed towards the most deprived. Governments also face various political pressures and constraints which affect their objectives and chosen instruments. Most governments are vulnerable to urban unrest and some get their main support from urban working classes. Policies which particularly affect this group — for example, removal of food subsidies, especially when combined with exchange rate devaluation and control over wages — may completely destabilize the government. The riots in Tunis show the political sensitivity of food subsidies.

*Philosophy:* Economic philosophy is a pervasive factor determining how people believe that the economy works and predicting certain consequences from particular instruments. The IMF broadly adheres to a monetarist view of how the world works, together with a neoclassical view of the effectiveness of prices. Although the declared intention is to react flexibly to the circumstances of particular countries, examination of programs in practice suggests a very similar approach to each economy, more or less irrespective of particular circumstances.

One fundamental reason for alternative conditionality arises from differences in views on economic causality — largely stemming from differences in philosophy — which lead to differences in view about the effects of various instruments. Some of these differences stem from radically different paradigms, as between monetarists, structuralists, Keynesians and Marxists. Others concern differences arising within the same paradigm (e.g., as to the precise supply elasticities). It is not possible here to summarize the nature of the many relevant differences. But it is useful to point to some of these differences which lead to a choice of different conditions in the adjustment package:

(i) *Structural bottlenecks:* The monetarist-cum-neoclassical adjustment package assumes that there are few structural bottlenecks. Yet in many countries — especially poor countries with heavy reliance on primary products — supply elasticities in response to price changes may be very low without other changes which relax

bottlenecks, for example transport improvement. This was found to be a factor in Zaire, for example:

There has been little or no success in boosting food and cash crops or in modernizing inefficient local industry. All sectors are hampered by a decrepit road and rail network which makes many parts of the economy only accessible by aircraft. In 1981, a combination of these factors led the IMF to abandon a three year \$1.2 b. recovery program. (*Financial Times*, December 30, 1983)

(ii) *The role of institutions*: Reaction by institutions — for example, organized workers, marketing boards, parastatals — can thwart or offset the effects of changes in prices following devaluation. In such situations an adjustment package needs to take into account the institutional structure and may need to incorporate proposals to change it.

(iii) *Country disequilibrium*: Almost by definition, an adjustment package is introduced when a country is in severe disequilibrium. The basic tools of neoclassical economics are designed to explore the implications of small movements towards equilibrium and do not relate in the same way to severe disequilibria. In such situations, the sudden introduction of “liberal” trade and exchange systems can have very severe effects on incomes, employment and inflation. This seems to have occurred in the case of the Southern Cone countries in the late seventies. (See French-Davies for developments in Chile).

(iv) *World disequilibrium*: Policies appropriate to an expansionary world with few trade restrictions may not be regarded as appropriate to a situation with severe world imbalances, growing protectionism and financial crisis. In the former a strong case can be made for regarding a multilateral trading system as best; but in the latter, it is possible that bilateral and regional arrangements may offer countries better prospects for expansionary adjustment.

(v) *Growth and inflation*: The Fund view, cited above, is that inflation control is necessary for sustained growth and (though this is made less explicit) that sustained growth will be the outcome of successful inflation control. Inflation control is seen to follow from tight monetary policies. As is well known, structuralists take a different view about the causes and cure for inflation. But apart from that, there are critical differences as to the relationship between

growth and inflation. First, there is the issue of whether inflation is consistent with economic growth — here the experience of Brazil, among others, counters the view that it is not. Secondly, there is the question of whether the deflationary policies — which it is generally agreed will reduce output in the short-term — will in fact lead to growth in the longer-term. Much depends on the effects on investment, both investments in infrastructure (especially for low income countries) and directly productive investment.

These are just a few of the differences of view which lead to different conclusions about instruments of policy. Empirical work has been surprisingly inconclusive about most of these issues, partly because they are not easily amenable to empirical tests; and where empirical tests do seem conclusive, imaginative economists may argue that there special circumstances which render them inconclusive. This process must be familiar to anyone who has followed the empirical literature on monetarism and inflation. As far as Fund programs are concerned, empirical investigations have shown them to have rather limited effects (see Killick for a summary). On balance they seem to have some positive impact on the balance-of-payments (but even this is not statistically significant), and no significant effect on other variables like inflation, growth, etc. The results do not support the view that the programs would have devastatingly negative effects on growth and investment. But neither do they support arguments that the programs are effective in achieving their major objectives. Alternative packages have rarely been investigated, although Papanek found evidence of successful expansionary programs in Bangladesh (1974-76) and Indonesia (1967-70) (see Cline and Weintraub).

Taking the differences in objectives and the differences in philosophy together, radically different adjustment packages could seem desirable to different parties, and thus joint development of programs could be very difficult. But only limited agreement is legitimately required: that is, agreement that the package would be likely to achieve the required turn-around in the balance-of-payments.

### **Tanzania: An Example**

It will be useful to explore briefly an instance in which alternative conditionality seems to be needed. I have chosen Tanzania because I visited Tanzania in 1981 to examine short-term adjustment

with special attention to basic needs. (For more detail see Stewart.) The alternative conditionality I devised then is by no means the only alternative package possible; nor does it necessarily reflect the preferences of the Tanzanian Government. However, it does indicate that alternatives are possible.

Tanzania has experienced acute balance-of-payments difficulties for some years. During this time, attempts to reach agreement with the Fund have never had more than very temporary success, and the World Bank has made some of its loans conditional on Tanzania reaching agreement with the Fund. The sources of Tanzania's difficulties have been twofold: a severe deterioration in the terms of trade as a result of developments in the world economy, and a very poor supply performance, with exports of agricultural products falling substantially in volume as well as price.

It seems that the IMF required a large devaluation, the removal of price and wage controls and relaxation of import restrictions, permitting imports to be allocated by price rather than administrative decision, together with the normal credit restrictions. Tanzania resisted these proposals vigorously, but seems to have offered little in the way of alternative conditionality. Hence a prolongation of the crisis. The crisis is having serious deleterious effects on productive capacity, agricultural production, and therefore exports, since shortage of foreign exchange is limiting essential inputs to the agricultural and transport sectors. It is also limiting inputs to the industrial sector which produces the simple consumer goods, such as soap and textiles, which form the "incentive" goods for peasant agriculture. The crisis is also beginning to have negative effects on Tanzania's previously rather good record on basic needs. Ironically, Tanzania has continued to receive high levels of aid per head, mainly in the form of finance for new capital projects, while shortage of foreign exchange for recurrent imports is reducing industrial capacity utilization to below 25 per cent.

An expansion of production of agricultural exports is essential for Tanzania to achieve an improved balance-of-payments. To achieve such an expansion, there is first a need for flows of imported inputs to agriculture and transport and for the production of simple consumer goods for the rural areas. Without these, changes in price incentives, following devaluation, would be likely to have little or no effect. With them, supply should increase even without changes

in price incentives. However, some devaluation would appear necessary to improve the financial position of the marketing boards, which were being run with very large deficits, absorbing a large proportion of bank credit and often failing to make payments to producers, or paying after a long delay. It should be emphasized that devaluation without an increase in production of consumer goods would worsen the situation, since the real incentive to rural producers would not increase, but there would be an inflationary impact on prices. Moreover, a large devaluation, if accompanied by price decontrol and wage control, would result in a very large cut in the real incomes of urban workers, which were already very low. Quite apart from the question of the justice of the distribution of burdens, to introduce a cut in real income of this magnitude would likely be politically dangerous.

The Tanzanian Government has been strongly opposed to the Fund package, partly for the reasons just discussed: it was believed that the package would be economically ineffective and politically disastrous. In addition, there was a deeper objection to the package. It seemed to represent the antithesis of the values that lay behind Tanzanian socialism. Although critics are quick to point out that many of Tanzania's policies have proved dysfunctional, in terms of growth and distribution, the Government is not prepared to move far in what seems to be a laissez-faire and capitalist direction. The failure to reach lasting agreement, however, will probably do more damage, economically and politically, discrediting the socialist experiment more effectively than almost any adjustment package. Both Tanzania and the Fund need to abandon their doctrinaire stances and consider alternative conditionality.

There are many possible alternative packages. The following contains the main elements of one alternative:

(i) A large and assured inflow of untied foreign exchange over a period of at least three years. This is essential to make it possible to expand exports. Such an inflow could be financed by the Fund, the World Bank and a redirection of capital aid.

(ii) All foreign exchange to be directed towards priority purposes — viz. agricultural inputs, transport and simple consumer goods.

(iii) A modest devaluation to improve the financing of marketing boards, and to provide some improved incentive to farmers.

This type of package might enable the country to improve the supply of exports and thus to provide a basis for recovery, and escape from the vicious circle whereby foreign exchange shortages result in reduced exports which increase the foreign exchange shortages. In contrast, a deflationary package which emphasized monetary aggregates alone would be likely to accentuate many economic and political problems. Indeed, this is what has happened, as noted earlier, in a somewhat similar case — that of Zaire.

A serious deficiency of the Tanzanian Government has been its failure to present a convincing alternative to the Fund package. One reason for this is that *any* adjustment package involves difficult political choices. In the one briefly sketched above, the cancellation of many capital projects would not be popular, nor would some other changes in the system of price control and import allocation (not described above) that are also necessary. But another reason is a belief that the Fund would not seriously consider alternatives to its own package. In most cases, the Fund has much less to lose by failing to reach agreement than has the country. Countries which are politically and economically peripheral are in a much weaker position to argue for alternative conditionality than countries central to the world's financial system. A third reason for failing to put forward an alternative may be the need for "alternative" technical expertise to do so. Tanzania has actually had a great deal of alternative expertise. But for some countries this can present a real obstacle.

## Conclusion

This paper has argued that Third World countries should present alternative conditionality to that of the Fund — i.e., policy packages which are likely to bring about the required turn-around in the balance-of-payments, but which are more in line with the countries' own objectives, philosophies and circumstances.

It seems that the apparent rigidity and uniformity of Fund packages may in part be due to failure on the part of borrowing countries to develop and present alternatives. Expert advice in devising and negotiating alternatives would be required for some countries, especially those which are small and low-income. This could be provided by various agencies, for example the Commonwealth Secretariat. There is a need for alternatives to be explored at a general

level and for experience to be accumulated on which individual countries can draw when developing their own alternatives. Properly developed, alternative conditionality should permit more expansionary adjustment, more politically acceptable programs and consequently programs which are agreed on more quickly and adhered to more persistently. While Fund conditionality tends to be rather stereotyped — a single model applied to most countries — it is likely that there should be a number of alternative models, incorporating special economic and political factors. It seems probable that different packages would be suitable for low-income countries dependent on primary products, for mineral exporters, for countries with a strong manufacturing sector that has been inward-directed and for countries with outward-oriented manufacturing sectors. Other factors would be a country's size and political variables.

Fund agreement to alternative conditionality may be dependent on the bargaining power of the borrowing country. In this case, the development of this option will initially depend on its adoption by countries with much bargaining power, and it may then be generalized to countries with less power, using the "uniformity of treatment" argument to justify the extension.

It is difficult to discuss the question of adjustment and conditionality on a country-by-country basis, separately from wider issues which affect the adjustment process. For example, greater availability of medium-term finance would greatly assist more expansionary adjustment, and might, in some circumstances, be essential to it. Adjustment by surplus countries would contribute to adjustment by deficit countries. Some solution to the debt problem would radically change the context in which adjustment takes place. But even without any of these reforms at a world level, country adjustment could be improved with alternative conditionality.

## **Appendix**

Article 1 of the Articles of Agreement of the International Monetary Fund:

The purposes of the International Monetary Fund are:

- (i) To promote international monetary cooperation through a permanent institution which provides the machinery for

consultation and collaboration on international monetary problems.

- (ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.
- (iii) To promote exchange stability, to maintain orderly exchange arrangement among members and to avoid competitive exchange depreciation.
- (iv) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.
- (v) To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.
- (vi) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

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## CHAPTER 13

### *Conception & Misconceptions of Adjustment\**

Sidney Dell

#### The Concept of Adjustment

The word "adjustment" has been so much used and abused that one is apt to forget what it is supposed to mean. Indeed, adjustment is now usually regarded as something that the other fellow has to do when things go wrong. Any idea that every international economic relationship is a two-sided affair seems to have vanished from sight, except where deficit countries have some leverage of their own, as will be shown subsequently. Generally speaking, if someone is in trouble, the presumption is that it must be exclusively his own fault, and he is likely to get short shrift unless he puts his house in order. The approach to the problem of distribution of the burden of adjustment to balance-of-payment disequilibrium is above all a question of power politics.

At the time of the Committee of Twenty's efforts to reform the international monetary system, the United States went so far as to argue that "Deficit countries would in any case be unable to restore equilibrium unless surplus countries at least followed policies consistent with a reduction of the net surplus in their payments positions."<sup>1</sup> In other words the sharing of responsibility for adjustment between deficit and surplus countries was not merely desirable, but indispensable, since in the absence of consistent policies by the two groups of countries, equilibrium could not be restored.

There is no controversy about the desirability, in principle, of symmetry in the adjustment process, and all pay lip service to it. As a practical matter, however, adjustment is almost invariably treated as involving unilateral actions by deficit countries — unless they happen to be reserve currency countries. There is little, if any, practical concern even as to whether unilateral acts of adjustment by deficit countries are being frustrated by countervailing activities

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\* Valuable comments by V.B. Kadam are gratefully acknowledged. The views expressed in this essay are those of the author and not necessarily those of the United Nations Secretariat.

of surplus countries, let alone as to whether the surplus countries are themselves taking steps to promote a return to equilibrium. The neglect of symmetry may be understandable in cases where deficits are relatively small and randomly distributed among countries, and where they are principally the result of domestic mismanagement. But where deficits are massive and system-wide, and result from common factors applying across the board to all or most countries, pressure for unilateral adjustment of the type seen in 1982-84 is not only inequitable but self-defeating. Simultaneous deflation by a large number of deficit countries is bound to compound their problems not only because of the consequential contraction in reciprocal demand but also because of the depressing effect on the level of activity — and hence import demand — of the surplus countries. Moreover, if deflation undertaken by deficit countries to deal with balance-of-payments disequilibria is accompanied by deflation undertaken by surplus countries as a counter to inflation, the stage is set for a cumulative downward spiral of economic activity.

In response to the critics of unduly harsh IMF conditionality, the point is often made that the measures required to restore external balance in a deficit country are dictated not by the Fund but by the objective situation confronting the country concerned, including in particular its capacity for mobilizing foreign exchange from its own resources or by borrowing. Given the limited availability of foreign exchange, the stringency of the measures required follows as inexorably as night follows day.

### **Adjustment and the Debt Crisis**

The basis for this contention has, however, been put in question by the measures adopted in dealing with the balance-of-payments difficulties that faced a number of major debtor countries beginning in 1982. The availability of foreign exchange was certainly not taken for granted in these cases; on the contrary, it was part and parcel of the negotiations undertaken. The IMF management acted in effect as an arbitrator between the deficit countries and their creditors (including the IMF itself as well as the commercial banks) in bringing about what was considered to be an appropriate relationship between the amount of belt-tightening required of the debtors

and the amount of finance to be provided by the creditors. The arbitration was based essentially on political, or at least non-economic, considerations. The political capacity of the debtors to withstand various possible degrees of retrenchment had to be measured against the degree of flexibility of the creditors in regard to the amount of financial resources to be provided. Thus the relationship of finance to adjustment was at the heart of the bargaining process; it was not a question simply of determining the amount of adjustment required in the light of a predetermined fixed volume of available finance.

This was no doubt an exceedingly crude and imperfect way of trying to introduce an element of symmetry into the adjustment process (always bearing in mind that the term "adjustment process" as used here is very far from implying the kind of structural adaptation that the situation demanded and continues to demand). In terms of the logic that the United States delegation, headed by Paul Volcker, employed during the deliberations of the Committee of Twenty in 1972, the concept of "symmetry", as applied to the situation in 1982-84, would at least have had to involve a deliberate and substantial reduction in the interest rates on foreign lending and a rolling back of protectionist restrictions on imports from the debtor countries. It is true that nominal interest rates did fall somewhat in 1983, but not as a deliberate act of government policy, and not sufficiently to meet the needs of the situation. Moreover, since nominal rates remained high while inflation decelerated appreciably in several major industrial countries, real rates of interest actually moved upwards.

In addition, one should not exaggerate the extent of the concessions made to the big debtor countries in 1982-83. In particular, the charges made by the commercial banks for rescheduling were exorbitant in terms of both interest premiums and front-end fees. The international community's tolerance of the rapacity of the banks was indeed deplorable.

Nonetheless, the negotiations between the principal debtors and their creditors in 1982-83 did involve an implicit, albeit minimal, element of symmetry. Perhaps the clearest indication of this was the fact that when certain commercial banks showed signs of trying to avoid new commitments to the debtors, they were warned by the IMF in unmistakable terms that unless they made their contribution to the financial provisions required, the Fund itself would not be

in a position to enter into the necessary stabilization agreements, with the result that the debtors would not be able to honor their existing obligations to the commercial banks among others.

### Major and Minor Debtors

This minimal symmetry was, however, reserved for the major debtors — for those whose difficulties were important enough in terms of magnitude to endanger the international monetary system as a whole and, more particularly, the financial health of the countries to which the major lending banks belonged. No such special provision was deemed necessary in cases that were not considered to pose such a danger. Indeed the difference between minor and major cases was deliberately institutionalized under the revision and expansion of the General Arrangements to Borrow (GAB) undertaken in February 1983. Under the new dispensation, non participants in GAB may obtain access to GAB financing on a finding by the IMF Managing Director, endorsed by the GAB participants, that the Fund faces an inadequacy of resources to deal with expected drawings by non-participants and that an exceptional situation exists associated with balance-of-payments problems of a character or size that could threaten the stability of the international monetary system.

If the difference between minor and major cases were simply a matter of the quantitative demands on IMF resources involved, special arrangements for mobilizing resources would be understandable, although even here it is arguable that under the Articles of Agreement of the Fund such resources should have been provided through the requisite enlargement of the quotas of all members rather than through *ad hoc* measures designed only for a particular category of members. But the main point is that the kind of negotiations undertaken by the Fund for the big debtors, and the margin of flexibility involved in such negotiations, are not available to countries that do not have access to the private international capital market for balance-of-payments support and must therefore rely entirely on the Fund for such support. The volume of support available to such countries is limited by the size of their quotas unless the Fund is prepared to waive quota limitations. This it cannot do under the constraints on IMF resources imposed by the industrial countries, which is itself a reflection of the weakening of the spirit

of international cooperation and of the adherence to a narrow commercial ethic. Moreover, even if valid arguments could be adduced in support of the refusal by industrial countries to provide for an adequate enlargement of quotas and of access by members to Fund resources, there is no reason why the Fund should not be permitted to borrow on a much larger scale from governments and in private markets.

Thus, in the case of low-income countries in balance-of-payments difficulties, there is no question of negotiating an appropriate relationship between the amount of retrenchment to be undertaken by the deficit countries and the amount of finance to be provided by the creditors. In these cases the amount of finance available is narrowly determined by the size of quotas, and the countries concerned have no choice but to live within these constraints, regardless of what this may mean in terms of disruption of the economy and of development programs — and regardless also of the degree of surplus countries' responsibility for aggravating the problem, through restriction of imports from the deficit countries, whether by direct or indirect means, or through deflationary policies leading to a deterioration of the terms of trade of deficit countries.

It would be wrong to conclude from the foregoing that the large debtor countries have received more favorable treatment from the international community than other countries. The stabilization programs required of the big debtors as a condition for balance-of-payments support have involved large sacrifices for them, and it would be difficult to measure those sacrifices against those of the low-income countries. Proportionally, the sacrifices of the heavily indebted countries may have been as large as or even larger than those of the low-income countries during the period following mid 1982. On the other hand, countries at a lower level of income were bound to be more severely affected by any given percentage of decline in real income, and these countries had not gone through an earlier period of rapid growth and development as many of the large debtors had.

### **Bringing Pressure on the Creditors**

The important point in all of this is that, in the case of the major debtor countries, international coercion was applied to creditors as well as debtors in 1982-83 and that this was a new experience in

the negotiation of stabilization programs. The experience demonstrated that the posture of the creditors does not have to be taken as given in such negotiations, but that the creditors themselves may be called upon to make an accommodation with the debtors. "Creditors" here refers to the commercial banks, but there is in principle no reason why the same considerations should not apply to the governments of creditor countries.

Consequently, it is necessary to reconsider the traditional argument that the degree of adjustment required of a particular deficit country is a simple function of the foreign exchange resources available to it, including a borrowing capacity that is fixed within fairly narrow limits. There are circumstances in which even the most tough-minded creditors may be prevailed upon to be flexible in their willingness to lend. Such flexibility has, of course, been demonstrated mainly in cases where creditors considered that the integrity of their own major banks was endangered, so that they themselves had something to lose. The implicit evidence of the GAB negotiations is that creditors at present are certainly not prepared to apply the same reasoning to the small debtors as to the large ones. But the principle has been established just the same — namely, that the burden of adjustment should be shared by creditors as well as debtors — and there are obvious reasons why that principle should be applied on a non-discriminatory basis.

### **Enhancing the Role of the IMF**

A further conclusion from recent experience relates to the role of commercial banks in the international monetary system. In order to bring the commercial banks into line, the IMF has had to threaten them with dire consequences, which demonstrates quite clearly that the private banks are unsuited to the task of providing balance-of-payments support. They had assumed this responsibility immediately after the first oil crisis because the resources of the IMF had been steadily undermined since the 1960s, as the industrial countries refused to keep increasing Fund quotas in line with world trade. The commercial banks, awash with liquid resources deposited by the capital-surplus OPEC countries, were only too happy to press their loans upon the creditworthy oil-importing countries, both developed and developing. They filled a vacuum at a time when there were no

alternative institutions ready to undertake the recycling of surplus funds that was required if worldwide deflation was to be avoided. But an institution having pretensions in the field of balance-of-payments support must be prepared to supply resources in bad times as well as good, and no financial institution whose principal purpose is profit-making can be expected to place the objectives of the international community above those of its shareholders, especially if significant risks are involved. There is therefore a strong case for re-building the resources of the IMF to the point at which it would take back the task of balance-of-payments financing from the commercial banks and thereby regain the importance that it had during the 1950s and 1960s as a source of balance-of-payments financing.

### **Adjustment and Growth**

Thus far we have discussed questions of equity and efficiency that arise when adjustment is unilateral rather than two-sided, and we have looked at the differences in the treatment of deficit countries according to whether their situations are believed to constitute a threat to the stability of the international monetary system.

A further key question is the following: How far is the kind of adjustment now being undertaken by developing countries appropriate in the light of their own economic situation as well as that of the world economy as a whole?

If one steps back from the body of dubious doctrine relating to this subject, it will be apparent that the term "adjustment" should include the concept of improving the ability of an organism to thrive in the particular environment in which it finds itself. In the case of balance-of-payments disequilibrium, to the extent that adjustment is required in a deficit country, it involves, or should involve, a process of change that reduces the chances that such a disequilibrium will recur. In other words, adjustment implies structural adaptation of a kind that will restore external equilibrium as well as the rate of growth of economic activity.

In practice, however, the adjustment process is viewed in a much more limited perspective. The main objective is considered to be the restoration of external balance without much regard to the general business conditions under which such restoration is achieved. For this purpose a reduction of aggregate demand suffices. This position

is sometimes defended by the argument that elimination of external disequilibrium through demand management will release the inherent forces needed for resumption of growth. But a mere reduction of aggregate demand does not improve the functioning of the economy in a manner that will make it possible to maintain external balance at a high level of activity. Thus, in a country that has restored external equilibrium by demand management alone, any effort to revive the level of activity and hence of demand may simply founder on a recurrence of the self-same difficulties that led to the original measures of deflation, wrongly entitled "adjustment".

In other words, there is a tendency to treat the "adjustment process" as if it consisted of nothing more or less than a reduction of aggregate demand. While such a reduction may well be an important component of an overall program of adjustment, in and of itself it contributes little or nothing to the adaptation of the economy to changing conditions. In fact, there is a sense in which the effects of deflation and of adjustment are in opposite directions. Deflation tends to reduce the ability of an economy to adjust because it slows down the momentum of investment which is indispensable to adaptation the change.

### **The Search for New Approaches**

For a time, in 1980 and 1981, the IMF experimented with policies that took greater cognizance of the structural aspects of external deficits than had been customary. This was accompanied by a major increase in the supply of resources, both gross and net, to developing countries. The Fund began advocating what it called "supply-oriented adjustment policies". Two approaches were envisaged. The first was designed to promote efficiency at a given level of aggregate nominal demand by reducing what were regarded as distortions caused by price and exchange rate rigidities, monopolies, taxes, subsidies and trade restrictions. The second approach aimed at enhancing the long-run rate of growth of full-capacity output, through incentives to saving and industrial investment, expansion of education and training, stimulation of technical innovation, and limitation of the size of the government sector.

These first approaches by the Fund towards the analysis of structural elements in balance-of-payments disequilibria were welcome, even though they fell far short of what was needed. In particu-

lar, they gave inadequate attention to sectoral imbalances and exaggerated the importance of prices and incentives as against the promotion of adjustment through investment and growth in key sectors of the economy. Alignment of domestic prices with world levels was assumed to be advantageous in all cases, often without any effort to assess the social costs that could result from a too doctrinaire approach to this subject. The penchant for limiting the size of the government sector smacked more of politics than of economics, especially where the government sector accounted for a significantly smaller proportion of GNP than in most of the industrial countries. But it is, perhaps, churlish to criticize a palpable effort by those concerned to make a positive and constructive response to the demand for recognition of structural change as a key factor in a sound adjustment process.

### **The Significance of the Indian Loan**

It was during this brief interval of IMF experimentation with new approaches to the adjustment process that the IMF loan to India came up for consideration. The history of this loan is of great interest, despite the fact that in many ways it was the exception that proved the rule. The conditions applied by the IMF to the Indian loan did not call for deflation: on the contrary, the Indian economy was envisaged as continuing to grow throughout the period during which drawings on the loan were to be made. But the Indian program was the subject of strong criticism by the United States, with the result that the period of IMF experimentation with supply-oriented adjustment was brought to an abrupt end, and subsequent stabilization programs in other countries reverted to the traditional deflationary model.

India approached the IMF for balance-of-payments support early in 1981, at a time when its external position was giving grounds for some concern but had not yet reached critical dimensions. This kind of early approach to the Fund was fully in line with previous declarations by its Managing Director regarding the desired behavior of deficit countries. In responding to criticisms of IMF conditionality, the Managing Director had argued that deficit countries were apt to leave it to the last possible moment to approach the Fund for help, and by that time the situation had often deteriorated to the point at which harsh measures were unavoidable. It would be better,

the Managing Director had said, for countries to consult with the Fund at an early stage of any deterioration in their balances-of-payments since this would make it possible to forestall a major crisis and thereby avoid unduly severe measures of retrenchment. These views on the need for early approaches to the Fund had been fully endorsed by the industrial countries, including the United States.

Developing countries generally were not inclined to place themselves in the hands of the Funds prematurely, but the Indian approach was certainly justified by the policies that had been enunciated by the Fund management. The adjustment process agreed upon between India and the Fund involved government investment in the energy and transport sectors within a general context of growth and at a high level of public and private savings and investment. It was envisaged that the requisite restructuring of supply, especially in the energy and transport sectors, would be firmly launched during the first two or three years of the program and that the investments contemplated would put temporary pressure on the balance-of-payments, calling for access to Fund financing. This kind of program was in full conformity with the requirements of the Extended Fund Facility (EFF) which had been established in 1974 to deal with cases involving the correction of structural imbalance.

### **The Rejection of the Indian Precedent**

The United States, however, was critical of the Indian program, which, it felt, would establish an undesirable precedent. Acceptance of the Indian program would amount to changing the whole character of the IMF, turning it into a "medium-term financial intermediary" instead of a monetary institution designed to provide temporary balance-of-payments support to member countries standing in need of such support. It was not the purpose of the EFF to help countries to maintain high growth rates. India could perfectly well reduce its deficit on current account by adopting a less ambitious investment program. If India insisted on maintaining such a program it should seek the requisite funds from the private international capital market, especially in view of the low level of India's debt service obligations. It was in any case not the function of the IMF to provide member countries with the resources required to sustain high levels of investment. The Fund should not act as a financial

intermediary but only as a "lender of last resort", analogous to the central banks of member countries.

In the event, the Indian loan was approved despite U.S. objections. It did not, however, set a precedent for Fund programs. On the contrary, while other developed countries had decided to support the Indian loan on an exceptional basis, they joined the United States in opposing any liberalization of IMF conditionality. In the latter part of 1981 it became clear that the leading industrial countries basically supported the philosophy underlying the position that the United States had taken on the Indian loan and that they would not be prepared to go along with a general application of the approach that had been taken in the Indian case.

### **The Abandonment of New Approaches**

This led immediately to abandonment of the search for new approaches to the adjustment process, and little further was heard of structural adjustment or of "supply-oriented adjustment policies." The conditions imposed for IMF lending were tightened once again, and they were made stricter still on the grounds that Fund liquidity had been reduced by the impact of the debt crisis beginning in the second half of 1982. This argument was largely specious, since Fund resources were being restricted artificially under deliberate policies of the industrial countries.

As a result, adjustment programs reverted to the traditional deflationary pattern. Moreover, countries were increasingly required to comply with certain "preconditions" which were to be satisfied prior to submission of programs to the Executive Board for approval. Although this was not a new practice, it had been employed only occasionally in the past. Now it became a customary feature of Fund programs. Although the preconditions are ultimately reported to the Executive Board, the Board's control is in effect preempted until after the event. Yet the preconditions may include measures of fundamental importance to the economy, including even exchange rate adjustments and the elimination of commodity subsidies.

Further tightening of conditionality is to be seen in the policy whereby a country that does not succeed in effecting the structural adjustment called for under an EFF program is not allowed to renegotiate the program even where failure is due to circumstances beyond its control. Additional IMF assistance, if available at all, is

provided only under a stand-by arrangement.

As recently as June 1981, the Fund staff had been arguing in favor of stabilization programs utilizing foreign borrowing to permit "higher levels of expenditures — as well as higher growth rates over the medium-term." These, together with the fulfillment of IMF performance criteria, would ensure that "the flow of output out of a given stock of resources is maximized."<sup>2</sup> This perception seems like a vision of Utopia when viewed against the draconian stabilization programs of 1983-84. Gone is any thought of symmetry or burden-sharing in the adjustment process. The concept of structural adjustment, to the extent that it is used at all in current discussion of balance-of-payments problems, has been deprived of all meaning, just as has the concept of adjustment itself. The World Bank, likewise, has not been able to make much practical sense of the concept, partly because of the entirely inadequate resources that it can devote to this purpose, and partly because Bank conditions for structural adjustment lending are normally superimposed on Fund conditions that leave no room for sustaining, let alone enhancing, the growth process. And one must say yet again that without investment and growth, there cannot be adjustment in any genuine sense of the world.

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1/ *Economic Report of the President* (1973), United States Government Printing Office, Washington, D.C., January 1973, p. 125.

2/ Manuel Guitian, *Fund Conditionality and the International Adjustment Process*, *Finance and Development*, June 1981.

## CHAPTER 14

### *Impact of IMF Conditionality on Human Conditions*

Uner Kirdar

#### The Role of the IMF in International Financing

It is a well-known fact that the actual amount of IMF financing of developing countries' deficits is small when viewed in the context of overall international financing. Yet the role of the IMF, its conditionality requirements and the policies which govern its financing are decisively important for developing countries. An unfavorable assessment of a borrowing country's economy by the IMF or rumors to the effect that a country is having difficulty in borrowing from the Fund may dry up other private and public flows to that country. At present the continuation of flows of commercial credits and of official aid, including the World Bank's structural adjustment loans, to most indebted developing countries depends on their ability to negotiate suitable policy packages with the IMF and ensure its "seal of approval." In recent years the complementary roles of the Fund and the World Bank and the collaboration between the two sister Bretton Woods organizations in the adjustment process have acquired increased importance. The Bank's lending to countries with balance-of-payments difficulties has become subject to their acceptance of the conditionalities contained in the IMF's stabilization programs.<sup>1</sup>

The use of Fund resources beyond the first credit tranche is conditional upon a country agreeing to certain adjustment policies and measures. For that purpose, representatives from the IMF and from the country's government sit down together to discuss the country's economic difficulties, while IMF advises on the causes of and the remedies for the country's balance-of-payments problems. If an agreement is reached on the diagnosis and on the terms of an appropriate "stabilization program," this is set out in a "letter of intent" to the Managing Director of the Fund, signed by the country's finance minister and accompanied by a "Technical Memorandum of Understanding." These documents give: (a) a description of the problems of the economy and the policies the government intends to

follow; (b) quantitative targets for adjustments in expenditures and savings, etc; and (c) quantitative ceilings for "performance tests," which serve as conditions for drawings on Fund resources over the duration of the stabilization program. All of the stipulations and information derive from agreements reached on the Fund's terms, and all reflect the Fund's philosophy.

The degree of conditionality varies according to the use of different Fund facilities and the size of drawings. Although all users of Fund resources *prima facie* accept the fact that their access will be conditional on their pursuit of so-called "appropriate adjustment policies," there are some misgivings about the methodology, philosophy and procedures by which the Fund works out a stabilization program, and about the nature of conditionality incorporated in it.

### Content of the Stabilization Program

Despite minor variations, in country after country the conditionalities contained in the IMF's stabilization programs are falling into more or less fixed patterns. The centerpiece of such programs is generally a devaluation of the currency to make the country's export products more competitive. This particular prescription is accompanied by measures for severe compression in demand, cuts in real wages, and measures to reduce government expenditures, particularly in the areas of human resource building and social development.

A typical Fund stabilization program demands curtailment in government spendings, including those for welfare services, special programs, and subsidies such as those for food, education and health care. The policy to curtail government expenditures is typically accompanied by policies to control the increases in wages and salaries in the public sector. The combination of these two sets of policies certainly has adverse effects, particularly on the poor segments of the population. Social tensions, strikes and riots are inevitable consequences.

Furthermore, irrespective of the causes of balance-of-payments problems, the Fund generally insists that countries follow deflationary policies. In the view of the Fund, countries with currency troubles have to adjust to changes in the external environment — such as a decline in the growth of world trade, increases in energy prices, the availability of concessional foreign assistance, higher

interest rates on external debt, etc. — even though these changes may not be under their control. These countries have no choice but to reduce their level of economic activity. In the words of the Managing Director of the IMF, such policies “will no doubt involve difficult social choices regarding education, housing, health and even public employment, but these choices have to be made.”<sup>2</sup>

This call to “tighten the belt” requires that all the tightening be done by the deficit countries and, within these countries, particularly by the poorest segments of the population, who are most affected by cutbacks in financing human resource development and social programs in such areas as education, vocational training, housing, health and public employment.

Since the net results of most of the IMF's stabilization programs are the creation of imbalances in income distribution and the reduction of growth rates during the program period, mainly by means of successive devaluations of national currencies, the economic foundations of the policies prescribed by the Fund are being questioned by many scholars and policymakers. Should not the Fund, an intergovernmental international institution, become more supportive of policies to bring about structural changes for “the promotion and maintenance of high levels of employment and real income, and the development of the productive resources” stated as primary objectives in its Articles of Agreement (I.ii)? Further reference to these primary objectives is made in Article I(v), which specifies that the correction of maladjustments in the balance-of-payments should be undertaken “without resorting to measures destructive of national or international prosperity.” According to Sidney Dell, the IMF seems to have strayed quite far from these “primary objectives of economic policy” in a situation of increasingly inadequate effective demand, growing underutilization of productive capacity and soaring unemployment, the pressure continues for even greater reductions of demand, which are likely to increase the volume of idle capacity and unemployment still further. The singlemindedness of the attack on inflation seems to have gone beyond the point at which trade-offs with other objectives are even considered, so that monetary restriction has almost become an end in itself. Dell states: “This is a distortion of IMF priorities, of the priorities of Article 55 of the United Nations Charter, and of the International Development Strategy drawn up under that Charter.”<sup>3</sup>

## **The IMF's Attitude and the End Results**

In a recent address on "Adjustment Programs Supported by the Fund: Their Logic, Objective and Results in Light of Recent Experience," the Managing Director of the Fund emphasized that during the past few years there has been a considerably increase in the scale of the Fund's financing in support of corrective policy measures in member countries. This has attracted greater attention than ever before to the role of the institution and has provoked a searching appraisal of the logic underlying the policies and programs the Fund has been supporting as well as their impact. The Managing Director recognizes that the conclusions have varied widely from an endorsement of the Fund's approach to criticism that the Fund's policies are too restrictive, too standardized and inimical to growth. In his view, with "the currently supporting adjustment programmes in more than 40 member countries, never before has there been such an extensive yet convergent adjustment effort. And the results of these efforts have been remarkable... The international financial community has responded to the challenges of the situation in a pragmatic way and with a high sense of responsibility."<sup>4</sup>

In its prescriptions of "adjustment measures," the IMF claims to be as "neutral" as possible. In its view, it is for the government concerned to decide what expenditures are to be cut. If a government decides to cut back in the area of human resource development, the impact of which is less visible than that of, for instance, cuts in industrial projects, that is too bad! As a "neutral" international organization, the Fund cannot intervene in the domestic policies of member governments. It is not a development agency and is not concerned with promoting economic growth. Its main objective is to correct maladjustments in the balances-of-payments of its members.

A primary purpose of the Fund, as stated in Article I of the Bretton Woods Agreement, is "to contribute to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members...." It would appear that the IMF's actions depart from this objective. In the negotiation of adjustment programs with member governments, the Fund's main concerns seem to be to ensure deflation by restraining the growth of domestic expenditures and by securing a "moderation" in wage increases both in the public and private sectors, and

to pursue a flexible exchange rate policy by implementing successive devaluations of national currencies.

The end product of such measures in many countries is stagnation or, even more frequently, negative growth in the economy. According to the IMF's adjustment programs, to prevent a high rate of inflation, wages and salary increases are to under strict control and allowed only on a minimal scale. In a country, for instance, where the inflation rate averages 60 or 70 per cent per annum, the wages and salary increases are permitted to be around 10 or 20 per cent at most, which means that both blue and white collar workers are bound to grow poorer. Furthermore, in order to reduce government subsidies of farm products, the IMF often recommends major increases in the price of fertilizers. Thus the rural population, normally the poorest of the poor, has to pay the biggest share of the stabilization bill.

Finally, to ensure that the country's export products can compete on the external market, frequent devaluations are also prescribed. If the rate of devaluation is higher than the rate of growth internationally, negative growth takes place, although in terms of the national currency a certain rate of development has been ensured.

### **An Illustrative Case**

The analysis presented here is supported by illustrations from various countries. Turkey, for instance, has a long-standing history of cooperation with the IMF. Lately, three separate stand-by arrangements have been concluded with the Fund, in 1978, 1979 and 1980. The latest covers a period of three years. Measures for income stabilization in the structural adjustments taken since the late 1970s have brought serious hardships to the largest segment of the Turkish population. During the negotiation of stabilization programs between the Turkish Government and the Fund in 1978 and 1979, a key issue was the raise in nominal wages. In the annual review of 1978, one of the main criticisms of the Fund staff with regard to poor performance was the negative influence of large wage settlements (between 40 and 80 per cent) obtained by the Turkish trade unions during 1978. A left-of-center government was the power at that time. The annual rate of inflation during the review time was 57 per cent. The rise in wages in 1979 continued to be in the same range, while the rate of inflation, as reflected in the wholesale price index

of the Ministry of Commerce, jumped to 81 per cent. In the period 1977-1979 the average real wage of organized workers belonging to social insurance rose by 37 per cent, while in the same interval, the average real salary of government employees fell by 26 per cent.<sup>5</sup> In 1981 the new government, in accordance with the IMF's stabilization program of 1980, exercised an important moderating influence over wage settlements, in both the public and private sectors. As a result of this policy, there seems to have been an average rise of 25 per cent in nominal wages and salaries, a far cry from the annual levels of 40-70 per cent prevailing in earlier years. This meant that a fall in real wages and salaries, since the inflation rate was around 40 per cent. Thus, the real purchasing power of government employees again declined drastically in 1980-81. According to a report to the Prime Minister from TURK-IS, the largest Turkish trade union federation, the share of national income going to wage and salary earners fell to 33.7 per cent in 1979 from 44.3 per cent in 1968.<sup>6</sup> The above-mentioned figures suggest that the hardships and burdens of the wage and salary earners have become still heavier since the late 1970s.

All the increases in wages and salaries which took place during 1978-1981 have been cited above in terms of national currency. During this period, the governments have implemented successive devaluations of Turkish currency in accordance with the conditionalities of the IMF's stabilization programs.

On March 1, 1978, in accordance with the stand-by arrangement with the Fund, the Turkish currency was devalued by 23 per cent. On June 11, 1978, the value of the Turkish currency was again lowered by 43.7 per cent from TL 26.5: US \$1 to TL 47.1: US \$1. In January 1980, a key measure of stabilization was a further devaluation of Turkish currency by 48 per cent, from TL 47: US \$1 to TL 70: US \$1. Since then, successive devaluations have taken place. At present, the value of a US dollar is around TL 325. Thus, not only has the Turkish wage and salary earners' share in the national income fallen but, on the international scale, their annual per capita income has also decreased considerably during the period under consideration.

There is no doubt that the primary responsibility for "the promotion and maintenance of high levels of employment and real income" in a given country belongs to the national government. It is equally true, however, that the priorities, policies and practices

of an international organization, created specifically to assist in the achievement of these aims, should be compatible with and supportive of the efforts of the government concerned.

### New Guidelines

In the face of mounting criticisms, the Executive Board of the Fund in 1979 adopted a new set of guidelines on conditionality for the use of the Fund's resources, which, *inter alia*, required that "in helping members to advise adjustment programs, the Fund will pay due regard to domestic social and political objectives, the economic priorities and circumstances of its members."

According to the former General Counsel of the Fund, Joseph Gold, this language has been added to the guidelines in order to "accommodate the views of developing members." The Fund expresses its intention by saying that it will "pay due regard" to the considerations listed. In the practice of the Fund, he states "the phrase connotes something less than a direction to give decisive effect to the considerations to which the Fund must pay due regard."<sup>7</sup>

It appears that, so far, this specific guideline has therefore not made a perceptible difference in the Fund conditionality practices. The Fund remains the object of continuous and increasing criticism from its borrowing members.

The Fund has shown little flexibility with regard to its conditionality. Debtor countries have either had to accept the conditions *in toto*, on the Fund's terms, as well as the Fund's philosophy for adjustment, or to reject it and thus be left in the limbo of permanent crisis. To date there has been no serious attempt at cooperation to work out alternative packages. There has been no objective technical inquiry into the Fund's operations and conditionalities, nor has there been an in-depth independent evaluation of the impact of its adjustment measures on human conditions. The examination of the Fund's operations has been carried out either by the Fund itself or by individual researchers, such as the ones around this table. The latter do not normally have adequate access to the Fund's confidential papers, and their findings are easily dismissed as being biased or inaccurate. One possible solution to this problem may be to establish an independent commission consisting of eminent economists from both North and South. This group would examine a sufficiently

large sample of the Fund's stabilization program to determine the extent to which the Fund's policies and conditionalities have been successful in achieving the economic and social objectives of the countries concerned and at what cost these objectives have been attained in terms of human conditions, employment, real income growth and development.

### **Latin American Experience**

1982 was known as the year of the Argentinian and Mexican debt crisis. 1983 was the year of the Brazilian debt crisis. This year has been predicted to bring a much more serious crisis to most of the Latin American countries: to big countries such as Mexico, Argentina, Brazil, Chile and Venezuela and to small countries — Costa Rica, Honduras, Guyana, and Nicaragua. The dilemma facing Latin American countries is how to reconcile the IMF's stiff austerity programs with rising demands from their populations for relief from the negative economic growth which is expected to become a common pattern and bring widespread distress.

According to Dr. Raul Prebisch, the present economic crisis in Latin America has resulted from a combination of such structural factors as:

- (a) a persistent external imbalance aggravated by the heavy weight of foreign debt, world recession, protectionist trade measures, a fall in commodity prices and high rates of interest in the United States;
- (b) the acceleration of inflation in the region; and
- (c) a very serious unemployment problem among large masses of people who are left at the bottom of the social structure and denied participation in the fruits of development.<sup>8</sup>

For these masses of poor people, unemployment has been added to a persistent condition of social marginality, which was not solved even when Latin America witnessed a period of prosperity in the industrial centers. Many benefits of development have gone to promote a society of privileged consumers. These countries have wasted a great potential for accumulating reproductive capital to increase productivity and multiply employment. The tendency by

countries to exclude large masses of the population from the benefits of growth and to neglect the need to take necessary measures for the development of human resources may be the main manifestation of the social inequity of the existing political systems. In the view of Dr. Raul Prebisch, great social disparities among different groups of the population have further aggravated the problem of inequity, by accentuating the inflationary spiral. Inevitably, signs of adverse political effects and social upheavals are emerging from this situation, and the great hope for a process of democratization in these Latin American countries could be frustrated by these conditions.

The remedies lie in a combination of external and internal measures, both short- and long-term. In that package, an equitable new income policy is needed. Austerity is not socially acceptable if the sacrifice is not equitably shared. Steps to increase the rate of reproductive capital accumulation should also be an integral part of such a policy, and should be geared to a long-term development policy.

Dr. Prebisch is also convinced that the IMF may play an important role in a reactivation policy, provided that it revises its conditionality requirements, in order to make them fully compatible with development policies, which, *inter alia*, will be geared to ameliorate human conditions and promote human resource building. The time has arrived, after years of experience, for a revision of the conditionality requirements of the IMF.

### Declaration of Quito

The views of the economic prophet of Latin America, Dr. Raul Prebisch, have recently been echoed in an official declaration of Latin American and Caribbean States at the Latin American Economic Conference of the Heads of State or Government of Latin America and the Caribbean which took place in Quito on 12-13 January 1984. The "Declaration and a Programme of Action," which was adopted as a Latin American and Caribbean response to the economic crisis affecting the region, states that the region is facing the most serious and intense economic and social crisis of this century. The crisis was brought on by internal and external factors. The latter, which were beyond the control of the countries of the region, included the trade, fiscal and monetary policies of certain

industrialized countries. These policies have led to a constant deterioration of trade, an inordinate increase in interest rates and a sharp contraction of capital flows. The overwhelming burden of external indebtedness forms part of this picture. The most harmful social effects of this situation have taken the form of an increase in unemployment figures unprecedented in the history of these countries, and a substantial reduction of real personal incomes and living standards, with serious and growing consequences for political and social stability. Adjustment measures taken by the countries have caused prolonged declines in production, employment and living standards. Therefore, the international community must also take adjustment measures necessary to eliminate the causes of the present situation. Within this context it is especially important to "revise IMF conditionality criteria — which, under present circumstances can endanger the stability and development — so as to give greater importance to the expansion of production and employment." The appropriate international organizations, such as CEPAL, UNCTAD and UNDP, should also provide technical assistance in renegotiating external debts upon the request of any country in the region.<sup>9</sup>

Frances Stewart, in her paper, "Alternative Conditionality," argues that the developing countries should present alternative conditionality to that of the Fund — i.e., policy packages more in line with their own objectives, philosophies and circumstances. The apparent rigidity and uniformity of Fund packages may in part be due to the failure of borrowing countries to develop and present alternatives.

Perhaps some hope can be found in the Quito Declaration and Plan of Action, in that it may lay the first foundation stone in working out alternatives to the conditionalities proposed by the IMF. In this context, I should like to express full agreement with the recommendation of both Frances Stewart and the Quito Programme of Action, that the relevant international organizations should provide necessary assistance and expert advice to the borrower countries in devising and negotiating alternatives to the IMF's conditionality and in their debt renegotiations. I strongly believe that UNDP, as a human development agency, has a special responsibility in this area. Specifically, UNDP could assess the impact of conditionality on human conditions and human resource development.

## Criticisms from the North

The views expressed here may be considered in some quarters to be biased, as they originate from experts of the South. It must be emphasized, however, that these views are also widely shared by some learned people from the North.

For instance, Sally Shelton, a former U.S. Ambassador to the Eastern Caribbean and Richard Niccio, a scholar at the Woodrow Wilson International Center, have recently written in the *New York Times* (January 22, 1984) that "the IMF's austerity programs have had high domestic social costs: doubledigit unemployment, reduced public spending and an absolute decline in per capita income in countries with virtually no social safety net... The harsh adjustments required by the Fund have hit all social classes: urban workers, the lower middle class, government employees, small businesses and even the newly emerging middle classes which are already slipping backward down the social and economic scale." These countries have been hit not only by the IMF's harsh conditionality but by the new U.S. legislation which discourages overseas lending by banks, when new money — \$60 billion — is desperately needed to service loans and provide new productive investments.

New York Congressman Charles Schumer, a member of the U.S. House Committee on Banking and Finance also recently published an article in the *New York Times* (October 24, 1983) which expressed the view that to prevent a default, the IMF often intervened to lend debtor nations some of the cash they needed to make interest payments, insisting in return that they "slash spending on vital social programs." The article illustrated that IMF conditionality is more like a hanging rope than a life-saving buoy for the borrowing countries. In order to demonstrate the economic and social impacts on human conditions of IMF's austerity programs, Congressman Schumer raised the question of "how Americans would react if they were forced to comply with the Fund's harsh adjustment requirements." He stated that "after one look at the \$200 billion federal deficit and the \$70 billion trade deficit, the Fund might well order Congress and the President to slash spending on all social programs such as food stamps, Medicaid, unemployment insurance and every other safety-net program, abolish cost-of-living adjustments for most current contracts, military retirees, social security recipients and

workers. Complying with the Fund's demands, the country's gross national product would plummet. Unemployment would rise to depression levels and the social security recipients, widows and orphans would be told to tighten their belts and allow inflation to reduce the real value of their benefits."

According to these authors, what should be done to overcome this crisis is, first of all, "to encourage the IMF to relax its stringent conditionality requirements, taking more into account the human costs of its programs." Second, banks should be encouraged to soften their loan conditions and increase their new lending; and third, the U.S. Government should set its own house in order to cut the federal deficit and lower the interest rates.

There is no question that certain adjustment measures are necessary in order to solve chronic balance-of-payments problems of developing countries. What is questionable, however, is the cost of adjustment. According to Tony Killick and associates of the Overseas Development Institute, the IMF unfortunately has not set its programs within a cost-minimizing framework.<sup>10</sup> It has tended to treat the balance-of-payments objective as an overriding one and has been reluctant to give weight to the governments' other objectives. In their new book entitled *The Quest for Economic Stabilization*, these authors urge that the IMF should adopt a new approach in its adjustment programs which would emphasize measures which stimulate output and productivity stemming from two sources: (a) improved utilization of the existing productive capacity; and (b) increases in that capacity. In this context, measures for human resource building certainly acquire new dimensions. "Capacity of management" becomes an essential supporting measure to the suggested new economic supply-oriented strategy, as an alternative to the conventional demand-management approach of the IMF. Similarly, in the view of Tony Killick and associates, the Fund's policies should, at a minimum, avoid the tendency to widen income disparities between nations and, within nations, should avoid adjustment measures which place the greatest burdens upon those least able to bear them. It is also necessary to counteract the adverse welfare effects on those already living in poverty.

## **Concluding Remarks**

In the light of the above analysis, certain suggestions can be formulated:

- Thought should be given to the convening of an International Conference on Human Resource Development in order to discuss all dimensions of this subject and to highlight the need to assign high priority in the development process to the building of human resources.

- There should be much closer cooperation among the World Bank, UNDP, IMF and other international agencies in order to assist developing countries in their efforts for human capital formation.

- UNDP and other relevant international organizations should provide developing countries upon request with the necessary assistance and expert advice in order to devise and negotiate alternatives to the IMF's conditionality, specifically in assessing the impact of the conditionality on human conditions. Similar assistance should be provided by these organizations to requesting borrower countries to assist them in their international debt negotiations.

- An independent commission of international economists should be established to examine a sufficiently large sample of the IMF's stabilization programs, to determine the extent to which the Fund's policies and conditionalities have been successful in achieving the economic and social objectives of the countries concerned and at what cost these objectives have been attained in terms of human conditions, employment, real income growth and development.

IMF conditionality should be linked not only to monetary and financial measures but also to specific levels of output, productivity, management, employment, increase in real income growth, and to a set of physical-quality-of-life indicators on which adjustments should be based.

- 1/ See Manuel Guitian, *Fund Conditionality, Evolution of Principles and Practices*, IMF Pamphlet Series, No. 38 (1981), p.27.
- 2/ J. de Larosiere's Lecture to the Africa Center for Monetary Studies on January 21, 1980, *IMF Survey*, January 1980, pp. 23-28.
- 3/ Sidney Dell, "Stabilization: the Political Economy of Overkill," in *IMF Conditionality*, edited by John Williamson (Institute for International Economics, 1983), pp. 17-18.
- 4/ See the text of the address by J. de Larosiere before the Center d'Etudes Financieres in Brussels on February 6, 1984, *IMF Survey*, February 1984.
- 5/ On this subject see Osman Okyar, "Turkey and the IMF: A Review of Relations, 1978-1982," *IMF Conditionality, op. cit.*, pp. 533-561.
- 6/ Osman Okyar, p. 558.
- 7/ See Joseph Gold, *Conditionality*, IMF Pamphlet Series, No. 31 (1979), p. 22.
- 8/ See *South*, September 1983, p. 67.
- 9/ Declaration of Quito and Plan of Action, from the Latin American Conference, Quito, 9-13 January 1984. See paras 5-14 of the Declaration and paras 1(b) and 3(iii) of the Plan of Action.
- 10/ Tony Killick, Graham Bird, Jennifer Sharpley and Mary Sutton, *The Quest for Economic Stabilization*, 1983. Overseas Development Institute, London, pp. 271-283.

## *A Comment*

**Arthur Brown**

I hope we are seeing the beginning of the end of the debate about whether adjustment is really necessary when a country finds itself in internal and external imbalance. For many, many years a good deal of the debate on the part of developing countries was to see whether there were some mechanisms available through which they could avoid adjustment. Indeed, the feeling was that adjustment was something imposed from above, by more powerful institutions. The developing countries do themselves a great service if they can now make this intellectual leap and accept that, in the long-term, adjustment has to take place — it has to take place because in its absence there is no opportunity for growth.

Now, where there is merely a temporary fall in the prices of commodities, countries can avoid adjustment to this. I often compare the situation of a country to the position of the worker who finds that his earnings are reduced because his employer is going broke and the employer is asking him to take a cut. Now he has two options: either he goes out and tries to get another job, or he adjusts his expenditures to his reduced income. He can avoid this at first by using up all of his savings, then by borrowing, but eventually he has to cut back to his lower income. We could regard the bankruptcy or threatened bankruptcy of the firm as analogous to the deteriorated external environment which faces a country. So far as I can see, it makes no difference whether the external or internal imbalance has been brought about by external factors or by internal mismanagement, except insofar as this may determine the type of help that one can obtain.

What I would like to look at is not the great international debate that takes place, but the reality that faces the head of the central bank or the minister of finance who has to adjust. He cannot allow things to ride, hoping for an international solution. This is not to say that we ought not to be working as hard as we can to achieve some of the types of solutions mentioned by many of the participants here. But in the meanwhile life continues, and I think we have been at fault in not developing a strategy to enable the economic decision-makers in countries to deal with the current situation as it

affects them.

Numerous volumes have been written and meetings held to analyze the international mechanism which are in place to deal with our long-term problems. And blame has been shared out for some of the failures of these international mechanisms. We have had a number of ingenious schemes proposed. But the simple fact is that tomorrow the country has to find interest payments on its debt, it has to provide foreign exchange for the bill just presented by Exxon for the oil which has been delivered, and it has to have foreign exchange for Pan-American, which wishes to remit a part of the proceeds of local sales in local currency. The international discussions cannot help the country at that stage; the country must find a way of coping.

Regrettably, there are many who adopt a passive attitude, always awaiting for something to turn up, and on this basis, postponing firm action. All the analyses have shown that the longer the postponement, the greater the inevitable adjustment. And one of the morals that we have to learn is that, faced with this practical and realistic situation, it is necessary to commence the adjustment, the international debate notwithstanding.

Now, it is a fact that the adjustment measures taken by many countries have been harsh socially and economically. A lot of the adjustment has been unfair, much of it has created political instability, and indeed there are some situations in which we could ask ourselves whether such a process can be called adjustment. I think everyone would agree, too, that an adjustment process which consists primarily of reducing imports is really not adjustment. In fact, bringing payments into balance merely by cutting back on imports is the beginning of further problems; there is no basis for growth in that kind of policy. I think it should be noted here that undoubtedly a good deal of the severity of the required adjustments arose from the delay in taking action, the hopeless waiting for some international solution to come to the rescue. We have had a false notion of an international net which would save us all, and we have not been willing to look ahead and take the actions which are necessary. Now, however, that is all in the past. And we must now ask in what direction we should move.

One of the issues that I have looked at is whether the one institution which was established to assist specifically in cases of payments imbalances, namely the Fund, has not been imposing two

heavy burdens on the countries — one being the repayment responsibility and the other, the responsibility to conform with some given standards of international behavior. The question is whether in putting this double burden on all the developing countries, the Fund has not gone too far, and whether indeed this is necessary in order to ensure that the international monetary and financial system is not disrupted. It is necessary to distinguish very clearly between the repayment obligation and, using a term coined by Sidney Dell, the grandmotherly function — defined by Dell as policies which the Fund believes are good for the debtor. The recommendation in Frances Stewart's paper is that we should assume that the legitimacy of conditionality is confined to meeting repayment conditions only, and then she prescribes certain actions that should follow. However, it is clear that neither the grandmotherly function, that is, what is good for the debtor, nor the limited role of a banker, making short term loans to governments, takes into account all of the history and justification for the establishment of the Fund as an organization. The Fund was set up with very lofty purposes: to promote international cooperation, to facilitate the expansion and balanced growth of international trade, and so on.

In reading Mr. Mohammed's paper (Chapter 11) I was interested to see that he mentioned on the very first page that the repayment function was one of the purposes, or indeed, the main purpose of the Fund's conditionality and lending. He says that Fund conditionality refers to the linking of Fund financial assistance to the adoption of corrective measures by a member country in order to achieve a viable balance-of-payments position such as will allow repayment to be made in the medium-term. Reading this, I was surprised, and I began to wonder whether indeed Mr. Mohammad had apostatized and was losing the true faith. However, later on in his paper, he comes back to orthodoxy and says that emphasis on the lending function of the Fund detracts attention from its other purposes and from the fact that its resources are available in order to promote these other purposes. The mandate to facilitate the expansion of international trade, to maintain orderly exchange rates among all members, and to assist in the elimination of exchange restrictions requires that the Fund take these matters specifically into account when considering the use of its resources. To suggest that the Fund should only be concerned with repayment, without regard to the purposes for which funds are being provided in the first place, is to

underestimate seriously the proper constraint on the Fund itself.

Thus the Fund is not acting as an ordinary banker, but is requiring of its debtors that they conform with two standards: first, the ability to repay, and second, the obligation not to take action which would disrupt the international financial and trading system. The question is, can we divide the conditionality requirements now imposed by the Fund into these two categories? Can we demonstrate that if it were not for the second requirement, conditionality would have been somewhat less severe? Even if this could be shown, I do not believe that it is viable at this stage to undertake a wholesale removal of this dual responsibility or to deny the basic purpose for which the Fund was created.

I do think that one might make a limited case for conditionality based on repayment alone. If one could find a collection of countries which, taken together, could in no way be regarded as having an ability to take action which would be destructive of international prosperity; if we could say that urging this group of countries, for instance, to remove trade restrictions would have no more effect than a blip on the international scene; if we find that, added together, these countries are not just at the periphery, but are totally irrelevant to the operation of the international trading and financial system, perhaps in this case it would be possible, without amending the IMF's Articles, to accept the argument that these countries should be given a conditionality which is linked solely to the requirement of repayment.

Of course, I am not saying that all of the other arguments for longer-term resources, that all of the arguments for program loans, should not also be present. But many of these countries now are flat on their backs. Irving Friedman has said that the collapse of the banking system did not take place and that to some extent we can ascribe this to the success of the international cooperation that is taking place. It is true the banking system did not collapse, but many countries did, and this is the problem that we have to deal with. We are also aware of the fact that the Fund is required to treat comparable cases in a comparable way, and so we must ask whether it is possible to find the rubric within which special treatment could be given to countries in a certain category.

Some time ago I made a calculation (and I recently updated it to take into account the new distribution of quotas) — using the percentage share of quota in the Fund as a proxy for the economic

power of the country — and asked myself what would happen if those countries with a quota share of one-tenth of one per cent or less were relieved from this double conditionality. And I found that of the 146 member countries of the Fund, 69 of its members have quotas of 0.1 per cent or less. And these 69 countries totalled a quota of 0.9 per cent. If the line is drawn at 0.2 per cent and less, the number of countries becomes 88, or 60 per cent of the membership of the Fund, with a total quota of 5.7 per cent. Now this latter number includes all the countries in sub-Saharan Africa, except Ghana, Nigeria, and the three Z's — Zaire, Zambia and Zimbabwe, all the Caribbean countries, all the countries in Central America and Panama, all the small South American countries, all the Asian and Pacific islands, except Singapore and Indonesia, and a large number of mainland Asian countries. Now, if we look at this measure of economic power and the ability of these countries to disrupt the international trading system, I think we will conclude that if every one of these countries came to the Fund at the same time for a program and were not required to fulfill this double duty, it would be very difficult to argue that this group could affect the international scene. And in fact, at any one time, even assuming the worst conditions, only between one-third to two fifths of these countries would have Fund programs.

Thus we must ask, is it not possible to seek within the Fund some understanding that these countries could be relieved of the second purpose of conditionality? Now, all of my theses, and all others which argue for the separation of the repayment function from the other responsibilities, assume that conditionality is more severe when both duties are applied than when only one is applied. Of course, if it can be demonstrated that this is not so, our argument collapses.

It would seem to me that the attitudes towards, for example, devaluation, price controls, import controls, and export subsidies, might well be different in a program in which one was looking at the ability to repay only. This does not mean asking the country to pursue policies which might not result in a resumption of internal growth. The point is whether it is possible to have a policy which does not impose an obligation to look at the effects of what you are doing on the rest of the world — to see whether relief from that responsibility would mitigate the severity of your conditionality.

And I am not saying here that one of the escapes is to repudiate debt.

All of this is said without prejudice to the other suggestions which have been made for increasing the resources of the Fund, for increasing the resources of the multilateral institutions, for a revision of net disbursements by the commercial banking system, for longer terms, and so on.

I would like to conclude with one other point. Within the developing countries analysis has shown that, quite apart from the external environment, management in the internal sector has been deficient. I think most developing countries' spokesmen, if prodded, will now acknowledge this. The ratio of blame between external and internal forces may be a matter for debate. In the recent OECD statement, of five suggested measures to be taken, three had to do with improving management of the economy, improving the level of skills, and improving research.

In the final analysis, it is difficult to manage the economy of a developing country when things are normal; it is doubly difficult when management has to cope with a crisis. In the recovery situation, what we have is a breakdown and deterioration of a good deal of the capital assets. For example, a mere increase in local currency earnings in the sugar industry, brought about by devaluation programs, does not automatically mean that sugar production will be increased, which is one of the assumptions that we make about devaluations. We must take into account the facts that over the prior five or six years the fields had not been properly attended, replanting had not taken place, spare parts had not been bought, the machinery had been run down, and the sugar industry had lost staff. All of these factors have to be attended to, and they all require a type of attention which is not taken into account in much of the conventional wisdom. If tomorrow you give the bauxite industry an increase in its local currency earnings of 50 per cent, it will not give you increased bauxite production, unless attention has been paid to all these other factors.

In summary, I want to say two things: first let us see whether we cannot do something for the small countries on the economic scene; secondly, let us go beyond some of the simplistic remedies and look at the overall programs of recovery and assistance for these countries.

## **PART V**

# **PRACTICAL RESPONSE TO DETERIORATING EXTERNAL ENVIRONMENT**

“The policy actions that would improve prospects for rapid and successful adjustment — a correction of the mismatch of monetary and fiscal policy in the United States, to reduce interest rates and depreciate the dollar; a fiscal stimulus in Europe; trade liberalization; and an SDR allocation — would also benefit the North. Whether they will be adopted is another question.”

— John Williamson



## CHAPTER 15

### *An Overview\**

Richard Feinberg

The global economy appears to be pulling out of the worst recession since the 1930s. But the strength and duration of the recovery initiated in 1983 remain uncertain. There are clear signs of progress, but problems linger. During the panel on "practical responses to a deteriorated external environment," Roundtable participants discussed the positive and negative developments in the world economy over the last year and suggested a series of measures that might enhance the prospects for a sustained and widely shared recovery.

#### Signs of Progress

Indications of progress were visible in the incipient recovery in the industrial countries; in the adjustment programs implemented in many developing nations; in the slower pace of commercial bank lending; in the orderly rescheduling of existing debt; and in the expansion of the resources of the International Monetary Fund. Led by a strong surge in the U.S. economy during 1983, commodity prices rose modestly and developing country exports began to expand. Fortunately for the debt-ridden Third World, nominal interest rates fell as inflation abated in the U.S. and other industrial states. As a result of these advances, fears abated that the international financial system might collapse and bring down with it the international trading system.

The non-oil developing countries have sharply reduced their aggregate current-account deficits from some \$109 billion in 1981 to less than \$60 billion in 1983. Mexico was the outstanding example of a country which turned its trade account from deficit to surplus with great speed. Moreover, in many developing countries, adjust-

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\* Based on the rapporteur's report, papers, presentations, and discussions in the workshop on this topic.

ment has occurred not only in external accounts, but also in relative prices. As Chapter 18 notes (Clark), many developing countries adjusted their exchange rates to improve their competitive positions. Whereas during the 1970s, many countries experienced a deterioration in their competitiveness — as domestic inflation was not adequately reflected in exchange rate adjustments — in the 1980s, devaluations substantially corrected this decline. Similarly, the high inflation rates of the 1970s had left many nations with negative real interest rates. In the 1980s, governments began to correct this imbalance by allowing interest rates to rise, so that by 1983, interest rates in most major developing countries had turned positive in real terms.

The decline in net bank lending was cited by some participants as a favorable development. Net new bank lending to developing countries was said to have fallen to roughly \$20 billion in 1983, thus expanding at a rate of about 5 per cent on an outstanding debt of \$400 billion. In Latin America, total bank claims had risen by some \$30 billion a year in 1980 and 1981. In the fifteen months from June 1982 to September 1983, bank claims increased by no more than \$6 billion. This correction permitted banks to rebuild their own capital-to-asset ratios, as well as potentially improving the debtor's debt service ratios and enhancing their future creditworthiness.

In an impressive display of coordination, energy, and innovation, the commercial banking system rescheduled over \$100 billion in debt. Having previously reserved rescheduling for exceptional emergencies, banks came to accept frequent, even regular, restructuring of loans. Indeed, banks have agreed to extend new loans as part of rescheduling exercises. As commented in Part V (Vojta), the large money-center banks successfully managed reschedulings involving hundreds of smaller banks. As some regional banks withdraw gradually from international lending, they have been persuaded not to declare to be slow-paying debtors in default. After this thinning out, the number of banks operating in international lending seems to have stabilized. Moreover, the establishment of the Institute for International Finance, with headquarters in Washington, D.C., promises to improve the flow of information on debtor nations to the commercial banking system. The new Institute may also assist its member banks in coordinating their own positions and

thereby contribute to a more orderly process for the rescheduling of debts.

The increase in the resources of the International Monetary Fund demonstrated the commitment of the industrial states to an open international financial system and their concern with the financial stability of developing countries. The industrial country governments realized that the decisiveness of the IMF in confronting the debt crises of Mexico and Brazil in 1982 was crucial in preventing an unraveling of the international financial system. When the private markets suddenly halted lending — in a freeze-up which might have left key developing countries without liquidity or the means to maintain interest payments — the IMF stepped in to fill a dangerous policy void. Moving swiftly, the IMF bailed out key LDCs by “bailing in” the commercial banks and the central banks of key industrial states. The IMF conditioned its own lending on the willingness of commercial banks to extend fresh loans to financially starved developing countries, while the U.S. Federal Reserve and other central banks provided short-term lines of credit. To continue to play this role and to meet the demand for funds from debtor countries, the IMF was granted a nearly 50 per cent increase in resources. Happily, the U.S. Congress voted to provide these funds without overly restrictive and punitive legislation that might have forced a counterproductive contraction in bank lending.

### **Signs of Weakness**

Notwithstanding these signs of progress, doubts persist. The recovery in the OECD countries may be too weak; the adjustment process in developing countries is far from complete; the commercial banks may have become too cautious; the rescheduling process may be postponing rather than resolving problems; and the IMF may still not have adequate resources.

Various projections by major institutions and influential private forecasters indicate that developing countries can recover, provided that the industrial world sustains growth rates of around 3 per cent and typically that LDCs' terms of trade improve, the OECD countries eschew protectionism, interest rates gradually fall, and adequate financing is available. These are clearly optimistic assumptions: the industrial world has managed barely 2 per cent annual growth in

the past ten years; and its twin fiscal and trade deficits could presage renewed recession in the United States in 1985 or 1986. Moreover, even a sustained 3 per cent OECD growth rate may not be enough to permit a healthy LDC recovery. Forecasters may be overestimating the elasticity of import demand in the OECD countries, since changing consumption patterns and rising protectionism may result in less trade-intensive world growth. In addition, about one-quarter of developing country exports are destined for other LDCs — many of whose markets have been contracting.

Chapter 17 (Williamson) reminds us of the distinction between “expenditure reducing” policies (which contract imports primarily through a reduction in income) and “expenditure switching” policies (which expand the production of exports and import substitutes through devaluation and control over foreign trade and payments). Expenditure-reducing policies can shrink imports quite quickly, as has occurred recently in Latin America. Expenditure switching policies are typically much slower acting. Lags may be especially long in developing countries, where the inelasticity of the production structure implies that a redirection of output between markets can be achieved only with a redeployment of resources between sectors. Many developing countries have not yet achieved this “structural change,” which is the prerequisite for sustainable growth. The evidence for the dominance of expenditure reduction over expenditure switching to date is the fact that, in the aggregate, the improvement in LDC current accounts has occurred more through a contraction of imports than through an income-generating expansion of exports.

Many developing countries not only are having great difficulty in adjusting production structures to the new international environment, but are not even managing their contractionary stabilization programs. As Chapter 18 (Clark) points out, many countries are still running large fiscal deficits, and the resulting expansion of the money supply is contributing to continuing high rates of inflation.

Many countries are failing to complete stabilization programs financed by the IMF. Programs are repeatedly being renegotiated and quarterly targets revised. There may be several reasons for this disappointing performance. Afraid of tarnishing their image of political neutrality, IMF teams have hesitated to take domestic politics into account. Yet, a political strategy is as necessary as a sound

economic model to make a stabilization program work. Moreover, although a "shock treatment" may sometimes be advisable, a rapid economic turnaround is not politically feasible in many countries.

Furthermore, despite the expansion in IMF resources and the IMF's pressures on the banks to extend involuntary loans to major debtors, the availability of external finance has sharply contracted. Industrial country members are stringently capping the amounts that the IMF can lend to individual countries. Levels of concessional aid are stagnant, equity investment is sharply down, and the commercial banks are retrenching dramatically. Some Roundtable participants argued that the banks were "overadjusting." Bank receipts of interest payments have been exceeding net new loans, transforming the international banking system into a net recipient of capital from the Third World. In short, inadequate finance has reinforced the contractionary forces in the world economy and made the process of adjustment in developing countries more difficult.

Perhaps more fundamentally, the IMF has been trapped in an environment not anticipated by its founders. The IMF was designed to promote open markets and global growth, and to assist nations to overcome balance-of-payments problems "without resorting to measures destructive of national and international prosperity." Finding itself in a prolonged global recession and with very limited resources, the IMF has felt compelled to recommend austerity programs which produce further contractions in world trade and economic activity. Without adequate financial means, the IMF has been unable to accomplish its original objectives.

IMF programs sometimes fail because political leaders lack the intellectual or emotional commitment to sustain a difficult austerity program. The commitment of many developing country leaders to implement politically costly stabilization programs has sometimes been weakened by their belief that the global recession was caused by forces beyond their control — whether OPEC price increases or OECD tight monetary policies — and that they are now being forced to shoulder an unfair portion of the costs of adjustment. Austerity measures are less politically acceptable when the ultimate beneficiaries appear to be international banks. Moreover, developing countries are well aware that while the United States preaches fiscal austerity abroad, it is running a large budget deficit at home, and this deficit is being financed by borrowing abroad. This borrow-

ing not only permits the United States to grow more rapidly than many developing countries, but also contributes to higher interest rates. As is noted in Part V (Vojta), the continuing U.S. fiscal deficits, the over-valued dollar, high interest rates, and political instability in certain Third World countries have resulted in a continued strong net capital inflow into the United States and other developed economies. Net foreign investment in the U.S. for the year ending September 30, 1983 amounted to \$49 billion. If this capital inflow into the United States continues, the U.S. stands to become a net international debtor. That the U.S. would become a net capital importer is a reversal of history and logic. From the viewpoint of developing countries, it is also an injustice.

An additional potential weakness in the global recovery is the huge debt overhang. Certainly, the commercial banks have handed a massive volume of debt rescheduling with impressive flexibility and innovation. Nevertheless, current practices are not fully satisfactory. Debt rescheduling exercises consume the valuable time of high government officials as well as bank management. Their frequency introduces an element of uncertainty in countries' finances. Reschedulings have sometimes become a source of friction between lenders and borrowers, and between industrial and developing country governments. Moreover, debt rescheduling may merely be a method for postponing problems. Some Roundtable participants warned of a future bunching of rescheduled debts in 1985-86.

Chapter 16 (Avramovic) emphasizes the dangers inherent in continuing high real interest rates that exacerbate the problems of a massive debt buildup. The ratios of debt and debt service are alarmingly high — whether the denominator be exports, GNP, government budgets, or national savings. At worst, this debt burden could precipitate a financial collapse and a global depression. At the least, it is a continuing drag on economic growth.

### **Policy Recommendations**

Numerous proposals were put forward to deal with these problems and uncertainties. It was emphasized that solutions should benefit all parties, and that persuasion would be more effective than confrontation. Attention focused on reforms that would facilitate a turn from expenditure reducing to expenditure switching

policies, from import contraction to export expansion, from short term demand management to longer-term investment in supply, from austerity to prosperity. To realize this transformation, and to enable countries to design politically sustainable adjustment programs, an increase in external finance was judged essential. Among the specific ideas presented were the following:

The resources of the IMF should be substantially increased, perhaps to double the present level. This would help the IMF to fulfill its original obligation of contributing to increased world trade and prosperity.

The IMF should issue additional special drawing rights (SDRs). An SDR allocation would help alleviate pressures on countries to repress their economies in order to rebuild reserves. Specifically, it was argued that assuming a world trade expansion of 4 per cent a year, an annual increase of roughly SDR 16 billion could be accommodated without undue inflationary implications. It was debated whether the SDR allocation should be made over a 3 or 5 year period, and whether it might be front loaded.

The resources of the multilateral development banks should be increased. Moreover, the difficulty and duration of the adjustment process — and the blurring of the lines between short-term stabilization and long-term development — required enhanced cooperation between the IMF and the World Bank.

Several additional proposals to increase capital flows were mentioned: secondary capital markets should be established for international loans; a trust fund be created to stimulate the return of flight capital; South-South financing be enhanced to complement North-South flows; and an international code for capital movements be negotiated. It was also suggested that developing countries, and specifically Latin American countries, exchange information among themselves concerning the bargaining tactics of the banks. The establishment of a credit information system, as advocated in the Quito Plan of Action, would help to counterbalance the advantages enjoyed by banks, which exchange information through their committees as well as through the new Institute for International Finance.

While higher levels of finance were considered crucial to a smoother and less painful adjustment process, other elements in the international system were also discussed. For example, it was recommended that:

— The United States adopt a more restrictive fiscal and a more lenient monetary policy, in order to be better able to sustain growth while lowering interest rates.

— The industrial countries avoid protectionism, in part by providing adequate adjustment assistance to firms and workers threatened by a surge in imports. Without access to export markets, debtor countries will not be able to earn the foreign exchange they need to service their debts and resume growth.

— Developing countries implement adjustment measures that “get prices right,” stimulate higher levels of domestic savings and more efficient patterns of investment, and reduce fiscal deficits and monetary expansion. Specifically, governments should avoid wasting resources on “white elephants.”

— The IMF undertake a thorough reevaluation of its role in a world where recessions may be prolonged and where private lending has assumed a large role. Ideally, the IMF should shift back to its original purposes of fostering global trade and growth and ensuring adequate global liquidity and an efficient exchange rate system.

— Governments act directly to reduce interest rates. Preferably, an international agreement would be reached to introduce ceilings on interest rates and thus enhance the regulation of capital markets (see Chapter 16 — Avramovic). Alternatively, developed country governments should reduce the interest rates they offer for their borrowings on capital markets. (Some observers, however, queried whether it would be possible to reduce interest rates significantly in this manner, and whether such actions might not freeze future bank lending.)

### **The Costs of Adjustment**

Even if many of these proposals are adopted, adjustment will be painful. All parties to the process have suffered. The industrial countries have experienced a deep recession and continue to confront massive unemployment and high real interest rates. Developing countries have also experienced substantial losses in income and employment, and many are now being forced to accumulate trade surpluses to balance net capital outflows. Prolonged recession and the popular perception of economic injustice are threatening the political stability of developing country governments.

For their part, although the commercial banks have not yet suffered massive defaults, they have witnessed the downgrading of their securities, the fall in the prices of their equities, and the need to accumulate reserves against potential losses.

Whether the distribution of the costs of adjustment has been equitable is a matter of heated debate. Several chapters in the drama have yet to be written, and only history will reveal the ultimate distribution of the burden.

## CHAPTER 16

### *Interest Rates, Debts and International Policy\**

Dragoslav Avramovic

#### Introduction

The issues of interest rates, length of repayment, and conditionality of lending are central to any attempt to deal with the international indebtedness and adjustment problems in a way which would constitute an advance from the present short-run and *ad hoc* practice. This article discusses interest rates: why they are persistently so high, their effects, and possible remedies. After a summary, the article opens with an assessment of the world debt and interest burden, and then analyzes separately the positions of developing and developed countries. This is followed by a review of possible causes of high interest rates: profitability of investment, uncertainty, deregulation and the nature of debtors' demand for loanable funds in circumstances of an already high debt-servicing burden. The concluding section outlines some policy implications.

#### Summary

At present levels of interest rates and of the stock of debt, world annual interest payments are probably larger than the annual increase in world income. The rate of interest in real terms is higher than the rate of growth of output. The world stock of debt is larger than world GNP. Deregulation of interest rates, widespread use of floating rates, and the shortening of maturities have eliminated the benefits to debtors from inflation. Under these conditions, it is virtually inevitable that a growing proportion of income is absorbed by interest payments. A part of interest is capitalized at high rates, leading to a cumulative growth of debt and debt service liabilities.

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\* *The views expressed in this article are those of the author and do not necessarily reflect those of the UNCTAD Secretariat.*

A massive redistribution of income and potentially of assets is taking place internationally and nationally.

The upward shift in real interest rates is not a result of high profitability of investment or of any corresponding increase in demand for real capital: profitability of investment has been falling in leading developed countries for a considerable period, and investment has suffered an absolute decline in recent years. Nor can the rise in real interest rates be accounted for to any large extent by the uncertainty premium which the lenders charge the borrowers because of the volatility of interest rates: this volatility has now been reduced and yet the rates have remained high. Budgetary deficits are frequently singled out as the cause of high rates: but, in addition to military expenditures, these deficits are themselves attributable partly to high interest payments. A hypothesis can be put forward that an explanation for present high rates may lie in the rates themselves: at the present enormous level of indebtedness, national and international, at the present low rate of growth of world economic activity and the correspondingly depressed level of real capital formation, and at present high interest rates, the demand for loans is to a large extent dictated by the need to pay interest on the stock of debt. It can be argued that in a number of cases the debt now has a life of its own, in a self-propelling mechanism of compound interest, which will tend to keep the interest rates up for as long as there are lenders willing to lend and debtors whose wages can be squeezed. As new lenders become scarce and wages cannot be depressed further, and if debt default is to be avoided, the only way to bring down the demand for loans and the associated interest rates is to cut the rate itself.

Action by individual countries to reduce the rates of interest is constrained under present conditions of international financial integration, as capital movements would tend to frustrate such individual efforts. Concerted international measures to introduce ceilings on interest rates and restore the regulation of capital markets would therefore be necessary. It is unlikely that such concerted action would be easily acceptable at present, in view of the economic philosophy prevailing in some major countries; and even some not sharing this philosophy may question this solution. An alternative would be for the key governments, in particular those of developed countries, to agree on a proportionate reduction of the interest rates they offer for their borrowing and that of their agencies.

Since the share of public sector borrowing in aggregate demand for loanable funds is large, average market rates should fall under the pressure of this collective monopsony of the buyers of funds. The feasibility and risks of such action should be investigated further; but it is difficult to see how the present unsatisfactory situation will be reversed without some such international effort.

### **World Debt**

Henry Kaufman, the well-known Wall Street economist, has estimated the outstanding world debt, exclusive of the debt of the centrally-planned economies, at \$14.3 trillion (thousand billion) at the end of 1981. It had grown at 15 per cent per annum in the preceding ten years (table I).

According to the World Bank, the world GNP, excluding most of the centrally-planned economies, amounted to \$9.2 trillion in 1980.<sup>1</sup> It probably increased about 10 per cent in money terms in 1981, to say, \$10.1 trillion. On this calculation and related to Kaufman's figures, world debt amounted to 141 per cent of world GNP in 1981, exclusive of centrally-planned economies.

This quantitative relationship between the stock of debt and gross income is roughly confirmed by the data for four key countries: on the average, debt works out at 150 per cent of their GNP (table 2).

In October 1983, the last month for which comprehensive data are available, the government bond yields, i.e. the closest approximation to the "riskless" long-term interest rates in these four countries, ranged from 7.2 per cent (Japan) to 11.8 per cent per annum (United States), averaging 9.4 per cent.<sup>2</sup> The weighted average would be in excess of 10 per cent in view of the volume handled in the United States market in relation to others, and probably higher still if all lending rates to all borrowers were taken into account: while short-term rates are lower than the long-term rates, the risk element is substantial over the entire time-horizon, pushing up interest rates for most borrowers except governments of a few developed countries. As debt has increased, the risk element has also risen, particularly in recent years.

World GNP in real terms is now increasing at less than 2 per cent per annum, and average price increases in countries accounting for

Table 1

Outstanding World Debt (Trillions of Dollars)

	<u>1971</u>	<u>1981</u>
	\$	\$
Domestic bank claims, 141 countries	1.7	6.6
Other domestic financial institutions	1.1	4.2
<u>Subtotal</u>	<u>2.8</u>	<u>10.8</u>
Eurocurrency market, net	0.0	0.5
Domestic and international bonds <sup>a/</sup>	0.8	3.0
<u>Total</u>	<u>3.6</u>	<u>14.3</u>

Note: a/ Eight major currencies.

Source: Henry Kaufman, *A Difficult Transition*, Address in Tokyo, October 19, 1982, Salomon Brothers Inc., New York.

Table 2

Credit-Market Debt as Percentage of GNP

	<u>1973</u>	<u>1975</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>
United States	159.7	163.3	167.9	169.2	167.2
Japan	155.4	160.3	180.7	189.5	201.3
Germany (Federal Republic of)	102.2	109.2	120.8	125.0	132.4
United Kingdom	132.0	115.5	105.7	104.3	n.a.

Note: a/ Debt owed by all domestic non-financial sectors.

Source: Bank for International Settlements, *Fifty-second Annual Report*, Basle, June 1982, p. 74.

most of it and expressed in dollar terms are down to 4.5 per cent per annum at the consumer level and 1.2 per cent at the producer (wholesale) level. It follows that world GNP in money terms increases at no more than 7 per cent per annum. This compares with the average rate of interest of no less than 10 per cent per annum, shown above. Since world debt stock is 1.4 times world GNP, annual world interest payments work out at twice the annual increment of world income  $[(14.3 \times 0.10)/(10.1 \times 0.07)]$ . This is not a sustainable situation: either output growth has to be restored to a satisfactory rate, or the real rate of interest has to be reduced, or the debt principal must eventually be scaled down. To the extent that interest is re-lent and capitalized, the debt grows at a compound rate: the problem is postponed but not resolved as long as the basic conditions of sluggish output growth and high interest rates prevail.

Inflation cannot be counted on any longer to provide significant relief to the debtors. Debt maturities have been shortened in some key countries, and floating rates have become widespread, thus making possible the indexation of loan contracts. In the United States, where new techniques have been used extensively, 60-80 per cent of long-term commercial and industrial bank loans in the last three years were made on a variable (floating) rate basis, while the average maturity of short-term loans fell from three months to one month, enabling a rapid adjustment of interest rates.<sup>3</sup> At the end of 1983, the market for fixed-rate Euro-dollar bonds was described as dead.<sup>4</sup> The corporate long-term bond market in the United Kingdom was considered to have virtually disappeared in the late 1970s.<sup>5</sup>

### **Position of Developing Countries**

Average interest rates paid by developing countries on their external debt roughly doubled between 1976-78 and 1981-82 to about 10 per cent per annum, in response to the rise in market rates and the rising share of market debt in their total debt, as low cost official lending increased much more slowly.<sup>6</sup> More than one half of the total debt is now owed to banks. Most of it is contracted at floating rates and is denominated and payable in dollars. These rates, consisting of the base rate (mostly LIBOR — London Inter Bank Offer Rate — and sometimes U.S. prime) and the margin to cover “country risk” (or, more broadly, “borrower risk”), are now running at 12 per cent per annum on the average. The real rate was

very much higher in 1981-82, when commodity export prices of developing countries were falling sharply, and it is probably still above 12 per cent for many debtors, despite a partial recovery of commodity prices in 1983. In the words of the Bank for International Settlements, "the 1981-82 decline in export prices meant that interest payments, which in earlier years had in large measure represented amortization payments, now entailed a real call on the debtor countries' resources and that the real value of the outstanding stock of debt continued to increase even without any borrowing".<sup>7</sup> The current depressed state of the copper market is attributable to "stable demand and increased output by nationalized mines in African and South American countries where governments are desperately short of foreign exchange."<sup>8</sup> Partial evidence suggests that prices of manufactures exported by developing countries are falling, as major debtor countries are making strenuous efforts to expand sales in the face of severe competition and frequently slow demand. The situation resembles earlier debt crises:

When credits are no longer extended to the same degree as before, cash-hungry debtors begin to liquidate inventories. Prices of many commodities begin to fall, a phenomenon long described by economists. The fall in prices makes life much harder for the debtors, because the value of the dollars owed, in terms of those commodities they are producing, is rising. It may even happen, as Irving Fisher so magnificently put it in an article published in *Econometrica*, 1933, first quarter, that the 'liquidation of debts cannot keep up with the fall of prices which it causes. In that case, the liquidation defeats itself. While it diminishes the number of dollars owed, it may not do so as fast as it increases the value of each dollar owed ... Then we have the great paradox which, I submit, is the chief secret of most, if not all great depressions: *The more debtors pay, the more they owe.*' (Fisher's italics.) Probably such a course of events is nowadays happening in some sectors of the economy, petroleum in particular. It would also be interesting to transpose Fisher's theory into the modern developing world, where it would appear that devaluation of local currencies in terms of dollars creates such situations as 'The more debtors pay, the more they owe' (the collapse being so far avoided because they are not required to repay and they are given fresh credits, compounding problems for the future).<sup>9</sup>

For non-oil developing countries as a whole, the proportion of exports absorbed by interest payments doubled to 23 per cent between 1979 and 1982.<sup>10</sup> For Latin America as a whole, the proportion in 1983 was estimated at a staggering 42 per cent (table 3). Principal repayments on medium- and long-term debt were estimated at another 20 per cent of export earnings, after the refinancings arranged or under discussion, making for a total debt service ratio of 62 per cent.<sup>11</sup> (With repayments of short-term debt the ratio would be even higher.) This is much worse than in the Great Depression of the 1930s, when the average of both interest and repayments for a group of eight Latin American countries did not exceed 40 per cent of exports.<sup>12</sup>

In six major debtor countries — Brazil, Mexico, Argentina, Rep. of Korea (South), Venezuela and the Philippines — annual interest payments abroad now account for 5 to 7 per cent of GNP, representing perhaps one-quarter to one-third of gross domestically generated savings, a formidable proportion on any reckoning.

At the present level of debt and an annual real rate of interest of 12 per cent, the debt burden of many debtor countries will grow with almost mathematical certainty. They will be compelled to borrow at 12 per cent just to make their interest payments; and debt will increase faster than real output. Brazil achieved an export surplus of \$6 billion in 1983, depressing domestic investment, consumption and employment in the process; but this was not much more than one-half of its interest payments due in this year, and debt continued to grow as the other near-half was capitalized, and it will now grow at 12 per cent per year on its own momentum. Mexico expects a trade surplus of \$7 billion in 1984, at the cost of a depression perhaps even deeper than Brazil's, but its interest payments are estimated at \$10 billion, and the residual must be capitalized. Both countries have cut imports to the bone.

The pressure on external finances has its counterpart in a liquidity crisis in the internal economy of many borrowers; in many cases, however, the domestic structural and policy factors also operate in generating a financial crisis. In Argentina, the annual equivalents of interest rates offered by affiliates of known international banks for seven-day peso deposits were reported in June 1981 at 250-300 per cent; and by smaller Buenos Aires finance houses up to 365 per cent, or 1 per cent per day.<sup>13</sup> In Turkey, the domestic interest rate in real terms was 45 per cent per annum in late 1982, in Brazil

Table 3

## Estimated Interest Burden of Some Developing Countries

	Estimated 1983 FOB merchand- ise exports (\$ billion)	Estimated in- terest due in 1983 as % of exports
Argentina	9	50
Brazil	22	46
Chile	4	50
Mexico	22	46
Venezuela	14	29
Total Latin America <sup>a/</sup>	96	42
Algeria	12	14
Indonesia	19	21
Republic of Korea	24	18
Philippines	5	48
Nigeria	12	11
Total other developing countries	330	12

Note: a/ Including Caribbean and other countries not listed.

Source: Kuczynski, "Latin American Debt: Act Two," *Foreign Affairs*, Fall 1983.

40 per cent at the end of 1982, and in Chile 50 per cent in early 1983.<sup>14</sup> Similar rates, which strain credulity, have been recorded elsewhere, causing widespread corporate distress. "At these rates, the liquidity of many productive enterprises is being drained, and they are near bankruptcy. The banking system is merely keeping enterprises afloat by financing the flow of interest payments, but there is little scope for new investment."<sup>15</sup> Devaluations have been an important factor raising the domestic cost of foreign borrowing and contributing to the cash-flow squeeze of enterprises. In Mauritius, a country with relative monetary stability, the effective domestic rate paid by the sugar industry on foreign borrowing, based on LIBOR of 10 per cent per annum, worked out at 18.51 per cent per annum in early 1983; at LIBOR of 14.5 per cent, it amounted to 23.34 per cent per annum.<sup>16</sup> In Latin America, where devaluations have been much larger, "the effect on the industrial private sector, which in (some) cases had been encouraged by the

policies of the authorities to borrow abroad, has been devastating: domestic sales in some cases have fallen by 30-40 per cent in real terms, as incomes have lagged behind inflation. This has sharply cut the ability of enterprises to generate cash flow, while the amount needed in local currency to service external debt has increased three or four times in the last year. It is not an exaggeration to say that a major portion of private large-scale industry in Latin America — not to mention chronically sick state enterprises — is today in effect bankrupt.”<sup>17</sup> According to the President of the World Bank, “thousands of enterprises throughout the developing world have gone bankrupt.”<sup>18</sup>

So long as the international market rate of interest stays at its present high level, the future debt servicing burden of all developing countries which borrow abroad (and not only of those already now experiencing difficulties in servicing their debts) will be very heavy indeed. In addition, the choice of investment projects which they might have undertaken had the cost of borrowing been lower is severely limited by the high interest charges, with the consequence that their rates of investment and of economic growth and hence their capacity to service their debts are impaired in the long-term. Protectionist measures adopted by importing countries, which limit the choice of profitable projects, and the increasing difficulties of obtaining concessional finance, give further impetus to these unfavorable tendencies.

### **Position of Developed Countries**

Excessive interest rates, “higher than at any time since the birth of Jesus Christ,” in the phrase of former Chancellor Helmut Schmidt, have deterred companies in developed countries from undertaking real investment. The companies have been reluctant to borrow at these rates, and this reluctance has been strengthened by poor demand in product markets. They have used much of their profits to accumulate cash or repay debts, and some have also engaged in lucrative financial investments. The financial structure, which had been severely strained several years ago and in many cases still is, is reported to have improved, but the real economy has experienced enormous losses in production, employment, investment and growth in the meantime.<sup>19</sup>

Interest payments have become a major element of budget expenditures, and they are now an important factor, together with military expenditures, in constraining public investment and social welfare. In the United States, interest on the public debt in the fiscal year 1983 of \$129 billion was equivalent to two-thirds of the budget deficit of the Federal Government of \$195 billion.<sup>20</sup> In Japan, service payments on public debt are equivalent to 71-77 per cent of the proceeds of new loans the Government needs to place to cover the deficit in 1984.<sup>21</sup> In Italy's 1984 budget, interest on public debt is likely to exceed 70 per cent of the deficit.<sup>22</sup> In Sweden, interest is equivalent to 80 per cent of the budget deficit of SKr. 80.8 billion (almost \$10 billion) projected for 1984-85. According to the Prime Minister, "One cannot just cut this much away from state expenditure. In today's situation we must do everything we can to hold the budget deficit at an unchanged level. Real reductions come from economic growth and a reduction in interest rates."<sup>23</sup>

Redistribution of income resulting from rising payments of interest on public debt has grown to major proportions: 3 per cent of the United States' GNP,<sup>24</sup> 3.3 per cent of that in Japan,<sup>25</sup> 8 per cent in Sweden,<sup>26</sup> and as much as 8.5 per cent in Italy.<sup>27</sup> The magnitude of the problem can perhaps be better grasped if it is realized that the debt of the United States Federal Government of \$1,360 billion is some 70 per cent larger than the entire external debt of developing countries, and it increases at 15 per cent per year.<sup>28</sup>

Public debts of developed countries are mostly internally held and income redistribution on account of rising interest payments therefore occurs primarily within national borders. This does not make the burden any less real. The budgetary problem it creates is severe. Furthermore, the distinction between the national and international debt stock ownership is becoming increasingly blurred owing to international financial integration. It is estimated that as much as one-fifth of the United States Federal Government debt, or the remarkable sum of \$270 billion, is now held abroad.<sup>29</sup>

Available estimates for individual countries, probably on dissimilar definitions, show the internal public debt stock outstanding in the range of 18 to 62 per cent of GNP in 1983, with an average of 35 per cent (table 4).

Table 4

International Public Debt as Percentage of GNP, 1983

Sweden	62.0
Japan	40.0
United Kingdom	38.0
Austria	34.0
United States	28.0
Germany (F.R.)	18.0
France	17.5

Source: *Le Monde*, 22 November, 2 December and 30 December 1983; *Journal de Geneva*, December 10, 1983; *Financial Times*, January 12, 1984.

OECD estimates, presumably based on a more consistent and complete coverage, show the government debt of the seven leading developed countries at more than 50 per cent of GNP in 1984, compared to less than 40 per cent ten years ago.<sup>30</sup> At present average interest rates, the amount of interest payments would work out at not much less than 5 per cent of GNP per year. To place this proportion in perspective, it is twice as large as the effect of the "oil-shock" in 1973 of 2.5 per cent of GNP of industrialized countries. The interest cost has now become a major component of "structural" budgetary deficits in developed countries, which in turn have moved to the center of the economic and political debate in many places. It is difficult to see how "structural" deficits can be much reduced without a substantial reduction of the rate of interest; and in the absence of such a reduction, income distribution will tend to become increasingly skewed.

### Interest Rates and Profit Rates

An essential point of Wicksell's theory of capital, which has influenced much of subsequent thinking in this field, concerns the relationship between the rate of profit, or the "natural" (or "normal", or "real") rate of interest in Wicksell's terminology, and the

actual, or "loan" rate, i.e. the rate actually charged by banks. The higher the profit rate (the "natural" rate) in relation to the interest rate (the "loan" rate), the greater is the demand for loan capital for purposes of investment, which will then push up the interest rate as well as commodity prices; and conversely, the fall in the rate of profit will depress the demand for loan capital and bring down the rate of interest as well as commodity prices.<sup>31</sup>

The upward shift of interest rates since 1979 cannot be explained in terms of Wicksell's theory. Profit rates had been declining in most leading countries since the mid-1960s, and investment fell in recent years. Available material leads to the following conclusions concerning profit rates for the period ending in 1982:

- (a) The rates of return on capital in manufacturing, measured by gross operating surpluses as a proportion of gross capital stock, show a consistent decline in the United States, Japan, Federal Republic of Germany and the United Kingdom; the same holds for Italy, where the measure refers to net rate of return on fixed capital;
- (b) Operating surpluses of non-financial companies in the United States, United Kingdom, Federal Republic of Germany, Japan and France have declined as a proportion of total net income;
- (c) The financial position of non-financial companies, measured by the proportion of equity (capital and reserves) in the capital structure, by the proportion of long-term debt in total debt, and by the internal financing ratio, has deteriorated in all the above countries for which data are available.

Investigations by Professors Lindbeck, Giersch and Wolter, and Denison have led to the same general conclusions regarding decline in profitability.<sup>32</sup>

In a reversal of this long-run tendency, profits rose considerably in the United States in 1983, in response to recovery in demand and a fall in taxes and lower costs of labor energy and imported inputs. This has led to a view that an increase in prospective profitability of real investment in the United States, as reflected in the 60 per cent increase in share prices as measured by popular averages since August 1982, has been a contributing factor pushing up real interest rates in that country.<sup>33</sup> It is difficult to accept this view. The increase in profitability did not lead to an increase in real investment

or to a rise of corresponding demand for loan capital for investment. In fact, it has been argued that increased profitability relieved the upward pressure on interest rates by keeping the credit demand lower than it would have been otherwise; in other words, interest rates would have been even higher if corporate profits had not recovered.<sup>34</sup> The fact remains that interest rates rose in 1979 and stayed persistently high in real terms in the face of a decline in real investment in 1980-82 and its probable stagnation in 1983.<sup>35</sup> It follows that causes of high interest rates do not lie in high profitability and increased demand for real investment, i.e. in the "real" economy. They must be sought elsewhere.

### **Influence of Uncertainty, Fluctuations, Inflation and Deregulation**

The failure of interest rates to fall despite the decline in inflation led to the view, particularly during 1982, that wide fluctuations in rates and uncertainty concerning their future level, generated by rigid adherence to fixed monetary targets in the face of changing demand, were by themselves a factor holding them up. In this view, bondholders had suffered heavy capital losses from time to time owing to wide variations of interest rates and of corresponding prices of fixed-income securities, and hence were not prepared to enter into long-term commitments without compensation for perceived risks. Consequently, interest rates now have to incorporate substantial risk and liquidity premiums.<sup>36</sup> A high official of the United States Treasury argued at one time that volatile monetary policy had added a premium of 5-6 percentage points to interest rates above the inflation rate.<sup>37</sup>

It does not appear that any systematic and detailed investigation of this argument has been undertaken. Interest rates became less volatile in 1983, and yet real interest rates did not decline as the uncertainty theory would have anticipated. While there is an element of truth in the uncertainty argument — increased risk normally leads to a widening of the spread between the purchase and the sale price — it is unlikely that it can provide a major part of the explanation for persistently high interest rates. Monetary policies, particularly in the United States, departed from rigid money supply targets after the liquidity "crunch" of 1982; a degree of stability in the money and capital markets was restored; but the rates remained high, and volatility is now much less frequently cited as a major

cause of high real rates of interest.

The expectation that interest rates will fall as inflation moderates has proved to be based on an oversimplified interpretation of Fisher's theoretical work. This work, it will be recalled, distinguished between two components of actual interest rates: the real rate, which reflects the long-term factors such as the productivity of capital and savings propensities, and a premium for expected inflation, which is added to the real rate. "Professor Lawrence Summers' study of the Fisher effect appears to demonstrate quite conclusively that American interest rates have not, over the past 120 years, systematically incorporated inflation premiums."<sup>38</sup> Furthermore, "according to Summers, Fisher himself had doubts how well his theory worked. In hundreds of the empirical equations that Fisher constructed relating interest rates to inflation, the largest effect he found was a 1:5 relationship. A five percentage-point decline in inflation lowered rates by only one percentage point."<sup>39</sup>

One explanation for persistent high interest rates despite lessening inflation is that lower inflation may result in an increase of demand for loanable funds in a situation of insufficiently rising or even falling supply. By slowing down growth in sales and product prices, anti-inflation programs as well as a spontaneous deflation will frequently reduce the profit margins and the volume of profits and incomes of the debtors, forcing them to increase their borrowing in order to maintain service payments on the existing debt. This interest-raising effect of a higher loan demand may swamp the interest-reducing effect of a lower inflation, particularly if the deceleration of inflation is accompanied by a decline in aggregate real income and hence in savings. This combination of circumstances happens frequently during the implementation of brutal stabilization programs. The unwarranted expectation that interest rates will fall automatically as inflation falls has caused a great deal of damage in recent years; financial crises strangling the debtors have ensued, instead of the smooth downward adjustment in interest rates that the anti-inflation programs had expected.

Deregulation of capital markets has helped push the interest rates upwards. For the United States, it is reported that an econometric analysis has shown that, by intensifying competition among financial institutions in raising funds and increasing their cost and by lifting interest rate ceilings, deregulation may have caused a quantum jump in interest rates.<sup>40</sup> More generally, in the indirect

language of the Bank for International Settlements:

The deregulatory changes in certain countries (e.g. dismantling of many deposit rate ceilings and usury laws in the U.S., removal of 'corset' and exchange controls in the U.K., and relaxation of exchange controls and of certain interest rate regulations in Japan) are reducing the role of credit availability and of 'non-price rationing' as a channel of monetary influences and are correspondingly adding to the burden of influence that must be carried by market interest rates... Financial institutions have come to rely increasingly on instruments bearing market-related interest rates in funding their activities. This liability management has increased their capacity to extend credit to potential borrowers. The counterpart of liability management has been the increased demand for such instruments by households and businesses which have become financially more sophisticated and more sensitive to the potential earnings loss from holding non-interest bearing or lower yielding financial assets.<sup>41</sup>

An informal survey has shown that the main beneficiaries of deregulation have been individuals and businesses with moderate to large balances, whose range of interest-earning opportunities has widened; buyers of financial services, i.e. investors, who can now shop around among banks and brokerage houses whose mutual competition has risen; and shrewd bank employees who can engage in imaginative financial deals across the world with decreasing barriers. The losers of deregulation have been many small businesses and farmers whose privileged access to low-cost funds has been reduced or eliminated as low-cost funds are disappearing; consumers with small balances, as increased bank charges have been frequently greater than the higher interest earned on deposits; poor people, who are faring the worst, as many banks have imposed monthly or quarterly fees on savings accounts with small balances, which may eventually erode part of the principal; homebuyers who now have to take the risk of floating rate loans or pay premiums for fixed-rate loans; and smaller and less clever brokerage firms and banks which are taken over by the larger banking concerns.<sup>42</sup> The end-result of deregulation should be greater efficiency in the deployment of financial resources, but in the meantime income distribution has become more unequal. According to some estimates, deregulation in the United States has raised the level of interest rates by at least

1.5 percentage points; and as about 20 per cent of the population is estimated to hold about 80 per cent of bank deposits, it is the minority which is the beneficiary.<sup>43</sup> In the developing countries, with a much more skewed distribution of financial assets, the effects are inevitably worse.

### **Debtors' Demand for Loans**

At present levels of debt and interest rates, a large component of the demand for loanable funds originates with debtors compelled to finance interest payments out of new borrowing. We know for a fact that this is the case with much of present borrowing by major developing debtor countries: new loans are being contracted, frequently under the official guidance of creditors' central banks or the IMF, to pay overdue interest or to avoid a failure to make interest payments by the due date. There are cases where interest payments made are immediately "recycled" to the paying country through an extension of short-term loans, thus capitalizing the interest and at the same time shortening the maturity structure of the debt. We also know that State authorities in a growing number of developed countries face the need not only to refinance the principal, but also to finance the interest on the public debt through new borrowing. Further, a large number of major enterprises in various economic sectors are known to have experienced financial difficulties and have required large assistance from banks, which had to refinance interest on past loans. More generally, a continuing growth in net credit in recent years, though at a lower rate than earlier, in the face of near-stagnation in production, declining inflation, and falling investment, suggests that it is the financing of interest on earlier loans by the grant of new interest-bearing loans that has contributed materially to the snowballing of debt. Funds raised by domestic non-financial borrowers in leading developed countries during the 1980-82 recession amounted to about 16 per cent of GNP per year, and there was no clear slowdown from the earlier years (table 5). There is a remarkable similarity between this proportion and the interest burden on the existing debt which, at 150 per cent of GNP in these countries and at an average interest rate of 10 per cent per annum, works out to 15 per cent of GNP.

Since demand for new loans is in part determined by the need to pay interest on past loans; and since a very large proportion of

past loans is now on a floating rate basis and subject to shortened maturities, so that the interest rates on past loans converge around the present rate, it follows that the higher the present rate the greater is the demand for new loans. This is a case of a higher price leading to an increase rather than a reduction of demand. In these circumstances, the only way to bring down the demand for loans and the associated interest rates is to cut the rate itself. The adverse effect on the supply of savings of an interest rate cut should be small, particularly if the cut is kept within reasonable limits and leaves the interest rate positive in real terms. Extensive investigations into the elasticity of supply of savings have led to a conclusion that their primary determinant is income rather than the rate of interest.<sup>44</sup>

### **Policy Implications**

Action by individual countries to reduce the rates of interest is constrained under present conditions of international financial integration, as large-scale capital movements would tend to frustrate such individual efforts. An international solution must be sought. Such a solution would call for an international agreement to introduce ceilings on interest rates and thus restore the regulation of capital markets. The likelihood of this happening at the present time, with the economic philosophy prevailing in some major countries, is small; and even some not sharing this philosophy may question such a solution. There may be another way around the problem, however. Governments, including those of developed countries, are borrowers in the capital market; should they be able to agree on a proportionate reduction of the interest rates they offer for their borrowing and that of their agencies, the average market rate should fall under the pressure of this collective monopsony of the buyers of funds, provided that their share in aggregate demand for loanable funds is sufficiently large. The effects of successive cuts in government offered rates would be to alleviate the position of the debtors, including most developing countries, help reduce the constraints on investment and growth, and raise the prices of the existing stock of bonds and shares. The required cuts in the developing countries' offered rates should be in principle smaller than the average, as their internal rates are frequently more repressed and their need to attract external capital is universally recognized to be large.

**Table 5**  
**Funds Raised by Domestic Non-Financial Borrowers**  
**As a Percentage of GNP,**  
**Borrowed by:**

		Business sector	Household sector	Public sector	Total	Public sector borrowing as % of total borrowing
United States <sup>a/</sup>	1975-76	4.0	4.3	5.7	14.0	40.7
	1979	6.1	7.3	2.4	15.8	15.2
	1980	5.5	4.5	4.0	14.0	28.6
	1981	5.1	4.1	3.7	12.9	28.7
	1982	3.9	2.8	6.8	13.5	50.4
Japan	1975-76	10.8	5.0	10.0	25.8	38.8
	1979	6.8	5.2	10.6	22.0	48.2
	1980	7.8	4.4	10.8	23.0	47.0
	1981	8.4	3.9	10.5	22.8	46.1
	1982	8.6	3.5	8.6	20.7	41.5
United Kingdom	1975-76	3.6	3.5	8.7	15.8	55.1
	1979	3.5	5.3	6.5	15.3	42.5
	1980	4.7	4.9	5.4	15.0	36.0
	1981	4.3	5.7	4.3	14.3	30.1
	1982	3.8	7.1	2.0	12.9	15.5
France	1975-76	7.7	4.9	4.2	16.8	25.0
	1979	7.4	6.2	2.9	16.5	17.6
	1980	9.0	4.5	1.9	15.4	12.3
	1981	8.3	5.1	3.4	16.8	20.2
	1982	7.7	4.2	5.4	17.3	31.2
Germany (F.R.)	1975-76	5.0	3.3	5.2	13.5	38.5
	1979	5.4	5.6	3.1	14.1	22.0
	1980	6.2	4.9	3.7	14.8	25.0
	1981	6.5	4.1	5.0	15.6	32.1
	1982	4.3	3.4	4.4	12.1	36.4

Note: a/ An alternative series for funds raised in U.S. financial markets as a percentage of GNP shows the following:

	Private sector	Government	Total	Government as % of total
1975-76	7.8	7.3	15.1	48.3
1980-81	12.2	5.2	17.4	30.0

Source: Bank for International Settlements, *Fifth-Third Annual Report*, p. 39; David Hale, Kemper Financial Services, as reported in *The Economist*, 14 January 1984.

Public sector borrowing in five major developed countries averaged 35 per cent of total borrowing in 1982; in the key market, the United States, the proportion was one-half (table 5). At this size, it would seem that concerted action by governments to bring down the interest rates would have a chance of success. The rate to aim at should be perhaps around 2 per cent per annum in real terms, "the historically typical real interest rate" in the words of the U.S. Council of Economic Advisers.<sup>45</sup> The average real rate in the postwar period 1963-82 in five leading countries — the United States, United Kingdom, Japan, Federal Republic of Germany and Switzerland — was lower, 1.1 per cent per annum.<sup>46</sup> This level may be more conducive to rapid economic growth, but it may also invite a greater risk of inflation, although the relationships are far from clear-cut.

The feasibility and risks of concerted action of this kind need to be investigated further. There may be serious snags in application and there will be objections on the ground of market acceptability, as well as on more philosophical or ideological grounds. The main risk is that priority needs of the public sector may be crowded out if there is a strong response of the private sector's investment loan demand to the decline in interest rates, for the rise in the private sector's demand might offset the reduction in loan demand resulting from lower financing charges. Responsiveness of business investment to changes in interest rates is one of the less explored fields of economic investigation both in theory and in empirical research; but what can probably be argued firmly is that business investment is unlikely to respond massively to a reduction in interest rates as long as there is significant surplus capacity.<sup>47</sup> Consumer investment demand, for housing and durables, has proved responsive to interest rate changes in recent years, but it is unclear whether this responsiveness would be repeated in countries where personal debt has reached a high level in relation to income. It follows that the apprehension that public sector needs will be crowded out may not be justified. Should it become a serious risk, different approaches would be needed, including action limited to alleviating the interest burden of developing countries only. Such partial action may be inevitable, although it would be inferior to a general solution through a cut in the international rate of interest: partial action would discourage new capital flows to developing countries for some time, while general action would not have such a discriminating effect and would also help alleviate the growing interest burden in developed countries.

Of course, if there is progress in arresting the arms race and in reducing military spending, crowding out of the public sector would be unlikely to materialize for some time. World military expenditures now run at \$750 billion annually. This compares with world interest payments, public and private, of at least \$1,500 billion annually. Together they absorb between one-fifth and one-fourth of world annual GNP. It would be an ideal world in which both expenditure streams could be reduced simultaneously.

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1/ 1983 Bank Atlas, *Gross National Product, Population, and Growth Rates*, Washington D.C., 1983.

2/ IMF, *International Financial Statistics*, January 1984.

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## CHAPTER 17

### *The External Environment and The Adjustment Process\**

John Williamson

#### 1. Introduction

The term “balance of payments adjustment” is sometimes regarded as no more than a synonym for reduction or elimination of a payments deficit. This is a mischievous usage. The *Concise Oxford Dictionary* defines “adjust” as “arrange, put in order ... adapt (to standard or purpose).” A balance-of-payments deficit that is suppressed by deflation that cripples domestic economic performance is no more “in order” or “adapted” to any useful purpose than is one that is being financed by an unsustainable capital inflow. Adjustment should, rather, be conceived as the process of adapting payments flows in order to make the best of whatever external environment a country is confronted with.

In terms of the concepts of James Meade’s (1951) classic analysis, adjustment is not simply the process of restoring “external balance” — a current account balance that is sustainable in the medium-term given the pattern of underlying capital flows. It implies also the simultaneous re-establishment of “internal balance” — as full a utilization of the economy’s productive resources as is prudent in the light of the need to control inflation. As Meade’s analysis showed, that requires the joint deployment of what Harry Johnson (1958) subsequently christened an “expenditure-reducing” instrument and an “expenditure-switching” instrument. Expenditure-reducing instruments are primarily fiscal and monetary policy, though nominal devaluation also has restrictive monetary effects provided these are not neutralized by monetary expansion. Expenditure-switching instruments consist of real devaluation and controls over foreign trade and payments: there are strong micro efficiency arguments

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\* *Helpful comments by William R. Cline and Mac Destler are gratefully acknowledged, with the customary caveat.*

for preferring devaluation under most circumstances, the main exception arising where war or some similar pressure creates sufficient social cohesion to limit resort to black markets and to promote overall saving rather than the mere diversion of luxury expenditures on prohibited imports. Expenditure-Switching requires a shift of resources from the production of nontradables into the tradable goods industries.

Expenditure-reducing policies can reduce imports quite quickly. Expenditure-switching policies are typically much more slow acting, although one advantage urged for import restrictions is that they may act faster than a devaluation. Even in industrialized countries it takes two or three years for a devaluation to produce its full impact on trade flows. Lags may easily be longer in developing countries, in those cases where the inelasticity of the production structure implies that redirection of output between markets can be achieved only with a redeployment of resources between sectors ("structural change"). The less developed the economy, the greater the likelihood that expenditure-switching will require structural adjustment.

The contrast between the rapidity with which expenditure reducing policies act and the delays inherent in expenditure-switching explains why a need for rapid elimination of deficit inevitably leads to severe recession. Hence the basic rationale for providing conditional finance to a country undertaking an adjustment programme: adjustment can be less costly, because internal balance can be more nearly preserved during the interim, if it is possible to continue to run a deficit until expenditure-switching measures have taken effect — but it makes sense to provide that finance only if the necessary expenditure-switching policies are in fact adopted and sustained.

There is a second reason that adjustment may be a lengthy process. If trade unions or other social groups with market power attempt to avoid erosion of their real incomes through devaluation ("wage resistance"), devaluation may not bring about the changes in price signals that are necessary to promote expenditure-switching. The achievement of adjustment requires action to change real income claims, and the traditional way to do that is through a recession. (The alternative, more humane path of incomes policy does not have an impressive track record to date.) Only as unions and other pressure groups have their claims battered into consistency with

reality will the process of expenditure-switching have a chance to get under way.

The above summary of the theory of balance-of-payments adjustment follows traditional textbook practice in concentrating on the national policies that are required. The IMF, which unceasingly preaches the crucial importance of correct national policies in achieving adjustment (see de Larosiere, 1984, for a recent case in point), would presumably approve. And this is indeed a vital focus: the appendix examines an interesting recent paper (Enders and Mattione, 1983) which shows quite clearly that deficient national policies were a major cause of the tragedy currently enveloping Latin America.

It is, however, one-sided to focus only on national policies. Changes in the external environment were also a major cause of the deterioration in Latin American economic performance, as can also be inferred from the Enders-Mattione paper. This general issue was first emphasized by Dell and Lawrence (1980). The present paper is intended to pursue the subject further.

The next section of the paper offers a taxonomy of the ways in which the external environment influences the adjustment process. This is followed by a discussion of the prospects for successful adjustment in Latin America, which draws on two existing studies and presents some new simulations that illuminate the respective roles of national policies and the external environment in achieving adjustment. Section 4 deals with the policy actions that could improve the prospects for the adjustment process.

## 2. A Taxonomy

It is possible to classify the influence of the external environment on the adjustment process under three main headings: its influence on the need for adjustment; on the timing of adjustment, via the availability of external finance; and on the ease of expenditure-switching, via the growth of foreign markets. These will be discussed in turn.

### *(a) The Need for Adjustment*

It was suggested above that adjustment should be interpreted as the process of adapting payments flows in order to make the best

of whatever external environment a country is confronted with. If a country starts off in internal and external balance, a need for adjustment can arise either because domestic policies change and create an unsustainable deficit, or because circumstances external to the country change. External shocks of a non-transitory nature may create or magnify, or at times mitigate or eliminate, a need for adjustment. The principal external forces that tend to alter the current account outcome resulting from given policies are changes in the terms of trade, in the strength of the currency in which most external debt is denominated, and in the rate of interest on foreign debt. Additionally, the appropriate current target may change, as a result of a change in the supply conditions of foreign credit; either an increased real rate of interest on foreign loans or decreased foreign perceptions of a country's creditworthiness would tend to reduce the target current account deficit.

It is evident that a number of factors have come together in recent years to create a need for adjustment in Latin America. The terms of trade worsened because of the world recession, the dollar (in terms of which most debt is denominated) appreciated, and interest rates rose to record levels. The rise in interest rates not only increased actual payments, but made it rational to seek to borrow less, as did the crumbling of creditworthiness.

#### *(b) The Timing of Adjustment*

The availability of external finance influences the possibility and advisability of delaying or prolonging adjustment. Abundant unconditional finance permits countries to delay initiating a needed adjustment: a "rational" government<sup>1</sup> will not avail itself of this option, but there are all too many myopic governments that do. Absence of external finance during the adjustment process compels excessive resort to expenditure-reducing policies until expenditure switching can take effect, as sketched above. Conditional finance is intended to combine availability of interim financing during the adjustment process with an assurance that effective adjustment will actually be pursued.

Latin America has experienced a violent swing from excessive availability of unconditional credit only three or four years ago, to a liquidity famine since August 1982. The sums available from

the IMF are far too small to meet the need for interim finance during the adjustment process, even supplemented by "involuntary lending" by the banks.

*(c) The Ease of Expenditure-Switching*

If export markets are growing rapidly, it is possible to expand exports by producing more goods of types that the country is already successfully selling abroad, and without encroaching on the markets of other countries. This facilitates and accelerates the process of expenditure-switching, the key to successful adjustment. (But note that this market growth effect relates only to "fixprice" goods, rather than to homogeneous commodities sold in organized markets: variations in external demand for the latter are mediated through changes in the terms of trade, which are more naturally considered as influencing the need for adjustment under (a) above.) The growth of foreign markets for what are often referred to as "non-traditional" exports depends on two factors: the rate of growth in the foreign trading partners, and the market access that they permit.

One reason for the contrast between the good progress in adjustment registered already by Mexico and the continuing difficulties being experienced by Brazil is the contrasting growth performance in their main export markets. Mexico sells non-oil exports primarily to the United States, where a strong recovery has been under way since the beginning of 1983. Prior to the recession, Brazil was selling over 50 per cent of its manufactured exports to other developing countries, whose markets have contracted severely in the past two years. Despite its membership in GATT, Brazil is also suffering more than Mexico from Northern protectionism, in particular from quota restrictions on footwear (in Europe), on frozen orange juice and sugar (in the United States), and from a countervailing tariff on exports of steel to the United States.

### 3. Prospects for Adjustment in Latin America

All seven of the major Latin American countries have now adopted adjustment programs, though this has been much milder in Colombia than elsewhere. Five of the seven have agreed programs

Table 1

The Initial Phase of Adjustment in Seven  
Latin American Countries, 1981-83

	Growth (cumulative %)	Exports		Imports (billion dollars)		Current Account	
	1981-83	1981	1983	1981	1983	1981	1983
Argentina	-3.4	9.1	7.8	8.4	3.9	-4.7	-1.9
Brazil	-3.9	23.3	22.3	22.1	16.0	-11.8	-7.7
Chile	-14.9	3.8	3.8	6.5	2.8	-4.8	-1.1
Colombia	1.7	3.2	2.9	4.8	4.4	-1.9	-1.8
Mexico	-4.5	19.9	21.0	24.0	9.0	-14.1	3.7
Peru	-11.6	3.2	3.0	3.8	2.8	-1.8	-1.3
Venezuela	-1.4	20.0	14.7	12.1	5.3	4.0	5.1
Total	—	82.5	75.5	81.7	44.2	-35.1	-5.0

Source: CEPAL, "Balance Preliminar de la Economía Latinoamericana durante 1983," December 1983.

with the Fund. In each case this has involved a mix of expenditure reduction, or austerity, and expenditure-switching, in the form of real devaluation. In most cases there seems little doubt that the austerity has been carried further than would have been necessary to secure simultaneous internal and external balance once expenditure-switching has become effective, but there may not have been any alternative, given the cutback in the supply of external finance.

The reduction in the current account deficit as a result of these measures has been impressive (table 1). In two years the deficit fell by \$30 billion. But this occurred entirely because of a precipitate cut in imports: exports actually fell. A major reason for the cutback in imports was the decline in income. Since this has pushed the region far below internal balance, the mere fact that the current account is now at a level that looks sustainable does not imply that adjustment has been achieved. There is, however, one encouraging aspect of performance to date: the decline in imports in 1983 was substantially greater (by some \$11 billion) than previous relationships between imports and growth would have led one to expect,

primarily because of a massive (\$8 billion) overshoot in Venezuela.

How rapidly it will be possible to secure enough expenditure switching to permit a resumption of growth remains a matter of conjecture. There are now several studies that have attempted to project future levels of growth, debt and balance-of-payments for the principal Latin American debtors. The results of the two that have provided the most detail, by Enders and Mattione (1983) and Cline (1983), are presented in table 2. Their base cases both assume *moderate but sustained* OECD growth, interest rates that change rather little from current levels, and a moderate rise in the price of oil at some stage. Latin American growth is determined endogenously by the DRI model in Enders and Mattione, and is set exogenously by Cline. Enders and Mattione project to 1987 for 7 countries, Cline projects to 1986 and does not cover Colombia. By coincidence the projected debt level for the seven in 1987 is identical to that for the six in 1986.

The general impression from a comparison of the two base cases is that the crucial difference in judgement relates to the availability of external finance: Enders and Mattione assume that this is (rather severely) rationed, and therefore require that countries follow low-growth low-deficit policies, while Cline assumes a growth rate and asks only later whether the projected outcomes could be financed. For Venezuela, and possibly Chile and Peru, the answer is negative. If one excludes Venezuela from Cline's figures, the 1986 current deficit/exports ratio falls to 12.3 per cent, much closer to the Enders-Mattione figure. For the larger countries, however, especially Brazil, there is a clear difference of view as to the future prospects: Cline is a great deal more optimistic about the possibility of resuming growth with a declining current account deficit than are Enders and Mattione.

For present purposes, however, the main interest of table 2 lies not in the base case, but in the differences from the base case that result from changes in the external environment or national policies. Additional simulations were run on Cline's model to generate results as closely comparable as possible to the Enders-Mattione estimates. Cline's model estimates that 1 per cent faster OECD growth would have a dramatic effect in almost wiping out the large current account deficit that persists until 1986 in his base case. Enders and Mattione record a much more modest impact — in part because Latin Ameri-

Table 2

## Estimates of the Outlook for Adjustment in Latin America

	<u>Enders-Mattione estimates for 7 countries</u>			<u>Cline estimates for 6 countries</u>		
	Foreign debt outstanding, 1987 (billion \$)	Current account deficit as share of exports, 1987 (%)	Cumulative real GDP growth, 1983-87 (%)	Foreign debt outstanding, 1986 (billion \$)	Current account deficit as share of exports, 1986 (%)	Cumulative real GDP growth, as- sumed 1983-86 (%)
Base Case	343	6.5	5.6	343	20.5	15.9
1% faster OECD growth	328	1.6	7.3	301	3.5	15.9
1% annual improvement in non-oil commodity terms of trade	320	0.6	5.7	n.a.	n.a.	n.a.
1% increase in interest rates	356	8.8	4.8	353	23.2	15.9
10% increase in oil prices	334	4.0	6.0	336	17.2	15.9
Real devaluation of 2.5% in 1984 and 4% thereafter	315	-1.8	4.3	333	16.0	15.9
1% faster growth in Latin America	n.a.	n.a.	n.a.	361	27.6	19.4
Devaluation with refiation	340	5.7	13.8	352	23.0	19.4
<u>Memorandum Item</u>						
1982 values	283	33.5	n.a.	269	36.1	n.a.

Source: Enders and Mattione (1983) and Cline (1983), and further simulations on Cline's model.

can growth is endogenous and therefore absorbs some of the increased foreign exchange earnings, but more importantly because Cline includes the effect of OECD growth on commodity prices in this term while Enders and Mattione include that effect separately. If Cline's assumption that a 1 per cent increase in OECD income raises commodity prices by 3 per cent is correct, the implied total effect of OECD growth would actually be larger by the Enders Mattione estimates. Changes in both interest rates and oil prices are estimated to have important but less dramatic effects (with oil price changes having much bigger distributional than aggregate effects), and both sets of estimates are of comparable magnitude.

The two policy options for Latin America considered by Enders and Mattione were devaluation and devaluation with reflation. The devaluation considered was modest, 2.5 per cent in 1984 and a further 4 per cent at the beginning of 1985, with the real devaluation subsequently maintained. It produced a quite noticeable improvement in the balance-of-payments prospects, but a small reduction in growth, presumably because of a negative real balance effect. Relaxation of the external constraint can, however, be utilized to stimulate growth quite substantially and still leave a stronger payments position, as shown by the last line. Cline's model gives a weaker stimulative effect of devaluation, which "buys" less growth. But devaluation still works, in the medium run.

Despite the sharp differences in their conclusions on the outlook for Latin America under the base case, there is a substantial measure of agreement between the two studies on the implications and importance of changes in both the external environment and national policies. It is quite clear that both matter.

#### **4. Policy Implications**

So far as Latin America is concerned, the main implication of the preceding assessment is obvious. It is essential to establish and maintain real exchange rates sufficiently competitive to hold out the prospect of achieving adjustment to the deterioration in the economic environment confronting Latin America.

If undertaken collectively by all the Latin American countries, let alone by all developing countries, real devaluation must be expected to produce a terms of trade loss. Whether collective or

isolated, it must be expected to have strong distributional effects, which will usually be unwelcome. Enders and Mattione argue that in Latin America the distributional effect typically bears particularly hard on the consumption pattern of the elite (foreign holidays, gunboats, etc.), and in some cases it may also bear on the urban proletariat. Where the private sector is heavily indebted in foreign currency, devaluation can also leave devastating implications for the financial viability of productive enterprise. And devaluation is inevitably inflationary. So a competitive exchange rate is not a soft option — which does not make it any the less an essential precondition for adjustment.

The principal purpose of this paper is, however, to seek the implications for the rest of the world, specifically the North. In doing that it is convenient to use three headings paralld to those utilized in section 2.

*(a) The Need for Adjustment*

Should the North be expected to select its macroeconomic policies with a view to minimizing the need for the South to adjust? Should it, for example, change the fiscal/monetary mix so as to reduce the interest rates the South has to pay on its debt? Should it aim to eliminate the overvaluation of the dollar, so as to make it easier to service debt? Should it aim at higher demand pressures with a view to raising commodity prices to more remunerative levels?

It happens that most of us believe those actions are precisely what the North needs to do in its own self-interest at the present time. There is therefore no immediate problem in dispensing policy advice.

Clearly this need not always be true. There will be times and issues when the best interests of North and South will be in conflict. The question will arise as to whether the North should be expected to modify its actions out of consideration for the interests of the South. (Is this what is meant by the demand that the North "share the burden of adjustment"?)

There is an instructive historical precedent. After the first oil price increase in 1973, the North in general and the United States in particular vehemently demanded that oil prices be rolled back because of their unacceptable impact on the world economy. OPEC was told, in effect, that it had a wider social duty than to maximize

its own income. By analogy, one might hope that the North would accept that its policies should be at least tempered by a concern for their impact on the South. But the precedent is not encouraging: OPEC did not roll back the price of oil. It seems doubtful whether the North will in the future be more moved by altruism than OPEC was in the past. It is more likely that, like OPEC, the North will feel that any deviation from maximization of its income should take the form of foreign aid directed at those whom it particularly wishes to help. It is likely that this criterion will largely exclude Latin America, except perhaps for Central America and the Caribbean.

A more promising possibility than preaching the need for greater altruism may be to seek to extend the principle that underlies the IMF's high-conditionality programs. These are not intended to be a mechanism whereby the international community pressures borrowing countries to abandon their own national interests and instead to act in a wider international interest. Rather, the intent is to bring to bear a body of experience and effective pressures to give weight to long-term interests in stabilization and adjustment. Future international monetary reform might be directed to enabling the Fund to perform the same sort of role in monitoring the policies of all its members.

Obviously such an extension of Fund influence would make sense only if one had confidence that the Fund would take a more penetrating and/or far-sighted view of policy requirements than its typical member government. There may be no reason to expect its analysis to be better informed, but there surely is reason to expect it to be less myopic. For example, the Fund would not have had an electoral incentive to recommend postponing action on the U.S. budget deficit till after November.

There is one way in which the IMF could directly influence the need for adjustment. At present all reserve increases, whether to replenish reserves in the aftermath of the debt crisis or on a routine basis to match the growth in trade, have to be earned by current account surpluses, or borrowed. This is unnecessary, given the existence of the SDR system. There is a very strong case for a substantial immediate allocation of SDRs to relieve the existing reserve shortage of the debtor countries, and for modest continuing allocations to match the real expansion of world trade (Williamson, forthcoming 1984). Such allocations would permit some scaling back of the targets for rebuilding reserves through payments surpluses that

are embodied in current Fund adjustment programs.

*(b) External Finance During Adjustment*

Recent Latin American experience has demonstrated that the sums available under the IMF's high-conditionality facilities are inadequate to avoid the need for precipitate elimination of a payments deficit. The case of Brazil is instructive: the need to achieve a big trade surplus quickly has led to a package of policies that have created a depression deeper than the 1930s and real interest rates of around 30 per cent (Dornbusch, 1983). It is difficult to see an investment boom in the export industries materializing while interest rates remain at these levels, whatever the profitability of exporting. Accordingly, expenditure-reducing policies appear to have been pushed to the point where they are actively impeding expenditure switching. The reason for this overkill is presumably the limitation on external finance.

The appropriate solution is a larger scale of potential IMF lending. Without this, it is pointless to complain of Fund policies, for less Draconian policies would not be financially viable.

It is much to be regretted that, under U.S. pressure, the Fund has moved recently in the opposite direction. The last quota increase was too small, given the demands on the Fund posed by the debt crisis.<sup>2</sup> Access to Fund resources was cut back from a maximum of 150 per cent of quota to a normal maximum of 102 per cent following the 1983 Annual Meetings, thus precluding increased drawing rights as a result of the quota increase. Given that the Fund's conditional lending is the basic way in which the international community seeks to ensure that the external environment is supportive of adjustment efforts, this retrogression has to be considered disappointing.

*(c) External Markets*

The importance of sustained and reasonably strong Northern growth to a rapid achievement of Southern adjustment is evident in the simulation results presented in section 3. But it has already been argued, under (a) above, that it is unrealistic to expect the North to modify its macroeconomic policies because of Southern needs. Fortunately the North also has a strong interest in securing sustained

growth.

Northern growth would not in itself be sufficient to ensure a growth of non-traditional exports from the South, even if accompanied by appropriate Southern policies. It is also essential that Northern markets remain open to imports from the South. Northern protectionism has the potential to create a major disaster, though Northern policy makers are aware that the South cannot hope to service its debts without exporting to the North, which gives some assurance that measures worse than the recent chipping away at liberal trade may be averted. One controversial question is just how bad the existing situation is. I have heard it claimed by influential policy makers that Northern protectionism is essentially irrelevant to the debt crisis because it is directed against the exports of the East Asian rather than Latin American NICs. Subsequent questions about the Brazilian situation have led me to construct the list of restrictions that appears at the end of section 2(c) above. It would be salutary if similar complaint lists could be compiled and publicized for the other major Latin American debtors.

## **5. Conclusion**

I have argued that both appropriate national policies and a supportive external environment are essential to the timely achievement of adjustment without excessive interim costs. Policies in Latin America have been adjusted in an appropriate direction, and even in some instances to an excessive extent. The need to resort to such drastic actions was a result of deficiencies in the external environment, especially the inadequate scale of conditional finance given the size of the adjustment problem, created in part by external shocks.

The external environment still offers the possibility of achieving adjustment successfully, albeit more slowly and at higher costs than would have been desirable. The policy actions that would improve prospects for rapid and successful adjustment — a correction of the mismatch of monetary and fiscal policy in the United States, to reduce interest rates and depreciate the dollar; a fiscal stimulus in Europe; trade liberalization; and an SDR allocation — would also benefit the North. Whether they will be adopted is another question.

Recent experience in Latin America has shown the appalling price of neglecting conventional canons of prudence and consuming

in excess of permanent income (see the appendix). This suggests two reflections. A first is that it is difficult now to be as optimistic as were Dell and Lawrence (1980), and other (including myself), that where payments shocks are externally caused there is a *prima facie* case for providing the victims with low-conditionality finance to permit a measured pacing of the adjustment process. There seems to be too much evidence that adjustment does not get under way at all until the financial pressures become acute. The appropriate remedy is therefore more generous provision of high-conditionality finance, rather than an easing of conditionality. The second reflection is that myopic behaviour is by no means the preserve of developing countries. It is ironic that the error of consuming in excess of permanent income is currently being committed in the United States and aggravating the troubles of the debtors. Perhaps the aftermath of a U.S. stabilization crisis (Marris, 1983) may provide an opportune time for both North and South to decide that they have a common interest in moving away from the infatuation with economic sovereignty and seeking some international mechanism to bring a longer time perspective to bear on the policy making process.

#### Appendix: The Genesis of the Current Depression in Latin America

Real GDP per capita in Latin America is estimated to have declined some 10.3 per cent since its peak in 1981 (CEPAL, 1983, table 3). This occurred in part as a direct result of the decline in external demand, but in larger measure as a consequence of the restrictive measures that most governments felt obliged to take to deal with their payments deficits. In either event, an assessment of the origin of the depression requires knowledge of the origin of the payments deficit.

Enders and Mattione (1983) have recently provided us with a careful calculation of the external causes of the current deficit of the seven principal debtor countries in Latin America. They base their calculations on a comparison with the period 1976-78 — a period during which two of the countries (Mexico and Peru) already faced a stabilization crisis, but when the four oil-importing countries in the group appeared to be in the process of making a reasonable adjustment to the first oil price increase, albeit at the cost of increasing external indebtedness (“debt-led growth”). However

**Table A.1**  
**Payments Shocks and Outcomes in Seven**  
**Latin American Countries, 1976-82**

	Current Account (1979-82 versus 1976-78)			Capital flight (1979-82, billion \$)
	Shock (average % of GDP)	Shock (billion \$)	Actual change (billion \$)	
Argentina	-3.0	-13.4	18.9	13.4
Brazil	-4.6	-48.5	-23.6	-2.1
Chile	-4.6	-4.8	-8.5	-0.8
Colombia	-4.9	-6.8	-6.6	-1.5
Mexico	1.6	11.7	-18.7	17.1
Peru	0.5	0.4	1.3	-0.8
Venezuela	7.8	19.1	19.5	15.8
Total	—	-42.3	-55.2	44.1

Source: Enders and Mattione (1983)

reasonable the base period may be, however, it is important to recognize that the results of the calculation are dependent on the choice of that particular period.

From 1979 on, the external environment deteriorated for the group as a whole. Following Balassa's methods, Enders and Mattione calculated the impact on the current account balance of changes in the terms of trade (at given trade volumes), of the rise in real interest rates on bank debt, and of the decline in the volume of non-oil exports (compared to the growth path of the 1976-78 base period) caused by the world recession. The dominant effect proved to be the change in the terms of trade caused by the oil price increase, which explains why the three members of the group that are net oil exporters actually had positive shocks (table A.1). Of course, had the base period been taken as 1980-81 when the oil price was at its peak, the oil exporters would also have been shown to suffer strong negative shocks, and it was in this period that Mexico and Venezuela encountered difficulties.

The calculated shocks are shown as an average percentage of GDP in the first column of table A.1, and (in cumulative form) in billions of dollars in the second column. The third column shows the actual change in the current account (with an adjustment for inflation) over the period 1979-82 in comparison to the annual rate for 1976-78.

It can be seen that the actual deterioration was greater than can be accounted for by external shocks for the seven countries together, to the tune of \$13 billion. This was primarily due to Mexico, which suffered a massive deterioration as a consequence of excessively expansionary policies despite a large positive shock from the oil price increase. Argentina and Chile also managed to magnify the exogenous deterioration, by allowing their currencies to become overvalued in an ultimately futile attempt to master inflation through the "strong currency option." Colombia and Venezuela did not adjust, as is evidenced by an outcome almost equal to the exogenous shock. Peru secured an improvement somewhat larger than its exogenous shock, reflecting a degree of success in the adjustment program adopted in 1978. Brazil achieved a substantial adjustment, but was left with a large deterioration and an even larger deficit.

The fourth column shows estimates of capital flight (measured by the sum of recorded short-term capital flows and errors and omissions). For the seven countries together, capital flight was almost as important as the deterioration in the current account and was actually larger than the exogenous current account shock. Capital flight was concentrated in three countries. In Venezuela, capital flight almost neutralized the current account improvement; in Argentina and Mexico, it aggravated the current account deterioration (and was almost as important).

Table A.2 examines growth performance of the seven countries. Growth slowed in six of the seven after 1979, the exception being Peru, which was recovering from its earlier stabilization crisis at the beginning of the second period. The Enders-Mattione projections (made on the DRI model) to 1987 show a recovery of growth from the 1982-83 depression, though this is sufficiently delayed in Brazil and Mexico as to leave growth on average slower in the later period even than in the period 1979-82. The final column shows average growth over the whole 12-year period 1976-87, incorporating the projections of the previous column.

Table A.2

**Growth in Seven Latin American Countries, 1976-87**  
**(average annual percentage rate of growth of GDP)**

	<u>1976-78 actual</u>	<u>1979-82 actual</u>	<u>1983-87 projected</u>	<u>1976-87 projected</u>
Argentina	0.5	-1.0	3.7	1.3
Brazil	8.6	2.8	-1.0	2.6
Chile	2.3	0.8	4.4	2.7
Colombia	7.5	3.3	4.7	4.9
Mexico	7.2	6.2	1.3	4.4
Peru	1.1	1.6	2.8	2.0
Venezuela	8.1	0.3	2.3	3.0

Source: Enders and Mattlone (1983)

What do these figures imply as to the relative roles of domestic policies and external shocks in generating recent troubles? They suggest that both factors **were** important — especially since both permissive national policies and external shocks were important in generating the massive capital flight observed in three countries.

More insight can be gained by examining the comparative experiences of different countries. Not only have the seven countries involved been exposed to very different external shocks, they have also pursued strikingly different policies. (Indeed, some single countries have pursued strikingly different policies over time.) It is, for example, surely instructive that the one country that has so far ridden out the debt crisis without going to the IMF or needing re-scheduling should be Colombia, the only country that pursued a serious attempt at stabilizing income and refusing to spend in excess of permanent income during the boom around 1977 (and in the process went out of its way to refuse to borrow). According to the Enders-Mattlone projections of growth to 1987, Colombia should end the 12-year period to 1987 with the highest cumulative growth of the seven countries. Yet Colombia actually suffered the proportionately largest adverse external shock of any of the seven. (Admittedly the base period was particularly favorable to Colombia.)

Table A.3

External Shocks and Economic Performance in  
Seven Latin American Countries

External shock, 1979-82 (% of GDP)		Payments deterior- ation, 1979-82 (% of GDP)		Reduction in % growth of GDP, 1979-87 v. 1976-78		% growth of GDP, 1976-87	
Colombia	-4.9	Chile	-7.4	Brazil	-7.9	Argentina	1.3
Brazil	-4.6	Argentina	-7.2	Venezuela	-6.7	Peru	2.0
Chile	-4.6	Mexico	-4.9	Mexico	-3.8	Brazil	2.6
Argentina	-3.0	Colombia	-3.7	Colombia	-3.4	Chile	2.7
Peru	+0.5	Brazil	-2.0	Chile	-0.5	Venezuela	3.0
Mexico	+1.6	Venezuela	+1.5	Argentina	+1.1	Mexico	4.4
Venezuela	+7.8	Peru	+2.6	Peru	+1.2	Colombia	4.9

Source: Tables A.1 and A.2.

A more systematic comparison between the magnitude of external shocks and subsequent economic performance of the seven countries is shown in table 3. The first column ranks the seven countries by the magnitude of the external shock, standardized as a percentage of GDP. The second column ranks countries by the severity of the total payments deterioration, from both the current account and capital flight, again standardizing by GDP. The third column ranks the seven countries by the severity of the decline in growth from the base period to the period 1978-87, assuming that the (rather pessimistic) Enders-Mattione projections are realized. The final column ranks countries inversely by their average actual growth performance over the whole period 1976-87.

The lack of connection between the size of the external shock and the deterioration in performance is evident by inspection.<sup>3</sup> Peru, recovering from a stabilization crisis, improved its performance most in terms of both the balance-of-payments and growth. The three countries with the largest deterioration in the balance-of-payments were those that allowed their currencies to become massively overvalued, while Mexico also created excess demand. Two of the three countries with the largest decline in growth were those that received substantial positive shocks. Quite clearly the IMF is justified by this evidence in emphasizing the crucial importance of

appropriate national policies.

But it would be as wrong to deny the importance of the external environment on the basis of these figures as to deny that of national policies. After all, Colombia followed policies which (especially in retrospect) it is hard to fault, and yet it suffered both a substantial payments deterioration and a substantial decline in growth.

Policy in Brazil has been less consistent than that in Colombia, but the current calamity clearly results from the interaction of both internal and external factors. Brazil sought to maintain an ambitious development program even after the two oil shocks. Northern bankers were sufficiently optimistic that Brazil would succeed in growing out of its problems to lend the money that financed debt-led growth. The bulk of this debt was contracted on terms that threw virtually all the risks on Brazil. Finally, changes in Northern policy made those risks materialize: the monetary stringency intended to turn back the inflationary tide also led to a collapse in commodity prices, smaller export markets, an appreciation of the dollar in terms of which most debt was denominated relative to other currencies (an effect that is not captured by the Enders-Mattione calculations), and record interest rates. While Brazil aggravated its problems by allowing a degree of overvaluation to emerge, by excessive expansion in 1979-80, and by a series of ill judged microeconomic policies, it was also a victim of external circumstances.

The only reasonable conclusion one can draw is that both sides in the argument about responsibility for the current depression in Latin America are right. There have been massive external shocks, which would inevitably have depressed performance. And there have also been misguided policies, which interacted with the external shocks to produce disaster.

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1/ The concept of rationality implied here is maximization of an intertemporal social welfare function with the customary properties. This is, of course, very much an economist's, rather than a politician's, concept of rationality.

2/ Before the last quota increase, I argued that an appropriate figure for the new level of quotas would be SDR 100 billion (Williamson, 1982), somewhat larger than the SDR 90 billion that was

ultimately agreed and approved. However, since the quota increase was accompanied by an expansion of the General Arrangements to Borrow, the Fund's resources were actually expanded by more than I had suggested. But the calculation in Williamson (1982) predated the debt crisis: had that been foreseen, a substantially larger quota increase would have been urged.

3/ The rank correlation coefficient is 0.29 between the external shock and the payments deterioration, indicating a slight but insignificant positive association; is zero between the external shock and the deterioration in growth; and is actually negative, though an insignificant  $-0.07$ , between the external shock and total growth.

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## CHAPTER 18

### *Economic Development: First Things First*

George J. Clark

#### Introduction

When the problem of the LDC debt is debated today, much is said about the desirability of a pick-up in the global economy, improved growth in the major industrial economies and in terms of trade, and lower global interest rate patterns as developments needed to ease the burden.

All of this is fine and as it should be. However, it leaves aside what the individual LDCs might be doing to contribute additionally to their own economic development. It is unfortunate that greater emphasis is not placed on self-action because:

1) Focusing upon external variables which are by-and-large not controllable by any individual country — including individual developed countries — detracts from concentrating on matters like exchange rates, budget deficits, and domestic interest rates which are controllable at the country level. This distraction may be fatal, as governments postpone decisions on matters over which they have control, in anticipation (often not realized) that external developments will move in their favor.

2) By failing to concentrate on domestic issues, the developing countries lose their best opportunity to maximize their growth. Domestic savings and resources are always larger than resources from foreign sources. If economic growth is to be achieved, the potential for productive investment from these domestic sources must be maximized. If domestic policies are not right, development does not occur.

3) To the extent that LDCs are perceived to be doing less than they might to maximize their own economic growth opportunities, they weaken the case for inflows of capital from foreign sources, because it is easy to argue “why should we outsiders try to help them if they aren’t helping themselves?”

### **Longer-Term Mismanagement**

Over the past ten years the LDCs have received one of the largest inflows of capital in all history, yet their financial situation remains precarious. Would more external resources provide the answer? Or does the answer lie in better domestic financial management?

In a broad sense, the major culprit of the lag in economic development is inflation. (In this regard my study shows that the situation is worsening). As domestic prices rise, the exchange rate tends to lag and becomes overvalued (my study argues that the great majority of developing countries have had overvalued exchange rates most of the time). The overvalued exchange rate discourages exports and capital inflows and encourages imports and capital outflows. This depletes foreign reserves and encourages exchange controls. The idea that governments can effectively allocate limited foreign resources through exchange controls is one of the most unfortunate misconceptions of our day and only worsens the process of rationally allocating these resources. Depleted foreign reserves and import controls compound the inflationary process by creating shortages of raw materials and spare parts needed for productive domestic activity, which further increases effective prices. Efforts to ease the pains of this inflationary process through indexing only make inflation more inevitable.

Local interest rates also lag in the course of the inflationary process. (My study shows that most developing countries have had negative rates most of the time.) Like overvalued exchange rates, negative interest rates provide all the wrong incentives. Consumption is encouraged, savings and capital inflows are discouraged and capital outflows are encouraged. It is true that cheap money encourages investment, but investments based on negative interest may not represent a productive allocation of resources.

Domestic wage policy also often works as a disincentive to sound investment and, consequently, is self-defeating. Local governments often mistakenly believe that they can improve standards of living and real wages by passing decrees raising nominal wages or by indexing of wages. When such increases are in excess of real output, the options are higher unemployment or higher inflation (reducing high nominal wages to lower real wages). Faced with this choice, governments commonly opt for inflation through increased monetary expansion at their central banks.

Inflation in the relatively simple economies of the developing countries is a monetary phenomenon. A quick reference to the International Financial Statistics will verify this, where money supply growth closely parallels the domestic inflation rate in country after country, year after year. Why do developing countries resort to so much money creation? The answer is that almost all developing countries now have their own currencies and their own central banks, and governments mistakenly see these as providing a mechanism to spend beyond their real income. They create and spend greater amounts of local currency, even though it is clear that this process creates no real resources and, therefore, cannot produce any real increase in output.

The difficulties created by inflation spill over to the debt servicing problem. In a recent speech (February 6, 1984) the Managing Director of the IMF remarked, "a recent Fund study shows that for those developing countries having significant recourse to commercial borrowing and having to reschedule their debt, monetary growth had exceeded 30 per cent annually in the five years prior to the debt financing problems. By contrast, those countries that managed to avoid rescheduling had kept their monetary growth rates at around 20 per cent. At the same time, while inflation averaged nearly 30 per cent for the former group, it was little more than half that rate for the countries that did not encounter debt problems."

To some extent, of course, the distorting effects of inflation can be offset by depreciating exchange rates and high nominal interest rates, to allow positive real rates. This appears to be happening more often in the last few years, but it did not happen sufficiently in the previous decade, which is one reason why the exchange rate/interest rate solution is only second best. It is better to get at the root cause of the problem and cut inflation. With high inflation, the temptation to have negative real interest rates and overvalued exchange rates is excessive.

Unless countries control inflation or at least offset most of its effects, they create an economic environment which so distorts the allocation of available resources that their possibilities for economic growth are severely limited. The problem is not only these macro-economic policies of money, inflation, real interest rates and exchange rates, although they are at the top of the list. Inflation also breeds price controls so that, for example, farmers do not produce

because price controls subsidize urban consumption of food. This is particularly unfortunate when agricultural goods are a major export and/or the exchange rate is overvalued, further depressing the local currency prices received by farmers.

Over the past ten years there has been a very large injection of resources into the developing world from the developed world. The biggest supplier of resources has been the commercial banks which have lent net new resources of over \$300 billion to the non-oil developing countries over this period. Additional public sector lending has provided another \$100 billion, and grant aid has provided another \$600 billion. This enormous transfer of resources is one for which history has no precedent. If such a transfer has not solved the problem, one must wonder how much more money is needed, or if the answer is rather first to correct the domestic policies.

Studying the economic policies pursued by the developing countries, one may be left with the feeling that many could scarcely have found a better mix of policies for avoiding economic development. How can foreign credit or foreign aid have a significant developmental impact if domestic policies are geared toward a misallocation of resources? Proper development programs are a necessary condition of development, and perhaps a sufficient condition. Aid may or may not be necessary. It is certainly not sufficient.

If one were to conceptualize a "dream program" for economic development, the following factors would probably be on the list:

1. policies which encourage savings and investment consumption;
2. policies which encourage investments in sectors where there is significant competitive advantage;
3. policies which encourages the holding of national currency vs. foreign currencies;
4. wage increases which reflect only increases in real output; and
5. freedom for market forces to determine investment decisions.

Against such a list, one must wonder if many developing countries have set out to implement policies to assure that any economic development which does take place does so in spite of, rather than because of the policy framework created by the local government.

## **Recent Encouraging Developments**

The following tables do suggest some hopeful new trends. Even though the rates of money creation and inflation are still rising in the developing world, the available data does suggest that exchange rates and domestic interest rates are currently being adjusted more rapidly and thereby off-setting some of the negative factors associated with high inflation. No doubt this progress reflects new policy measures under the IMF adjustment programs.

However, little long-term comfort can be taken from these developments so long as the basic inflation rates continue to be so high and rising.

## **Statistical Review**

The following are comments on a series of tables developed by the Institute of International Finance (IIF) which gives us the most comprehensive data source available to date for a review of the comments made in this paper. These tables are Nos. 1-4 and 6 attached. Table 5 is from a study by the IMF.

### *a) Budget deficits and credit creation*

The message is clear from the IIF figure attached. Budget deficits have been huge and growing as a percentage of GND/GNP (table 1). And credit creation to finance these deficits has accelerated through 1982 (table 2).

### *b) Money and Inflation*

The result has been an accelerated growth of money and inflation for the LDCs overall, as shown below (for the 23 countries covered by the IIF, see table 3):

### *c) Real Interest Rates*

The IIF indicates (table 4) that for all the countries covered, from 1973 to 1981 at least half had negative real interest rates, and in some years over three-quarters of the countries had negative rates. In 1982 the percentage dropped to 29 and tentative indications

### Non-Oil Developing Countries

	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1976</u>	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>
M1 + M2 %	33.0	29.7	25.9	37.8	36.8	36.2	37.0	38.4	37.8	41.6	46.0
Inflation											
CPI %	20.7	24.8	23.7	25.1	26.3	23.5	27.1	32.4	31.6	34.3	40.0

Source: International Financial Statistics.

are that the percentage with negative rates dropped further in 1983, presumably reflecting in part the IMF programs.

A study by the IMF (Occasional Paper 22, "International Rate Policies in Developing Countries," October 1983) based on a slightly different methodology came to the same conclusion (table 5). Covering 37 countries, the percentage of countries having negative rates was 59 per cent in 1978, 84 per cent in 1979 and 54 per cent in 1980. Taking into account the differences in methodology, these results are broadly similar to those in the IIF table.

#### *d) Competitive Position*

Focusing on the competitive position of countries — how much the exchange rate against the dollar is depreciated when local inflation exceeds that of the U.S. — is shown in table 6. Minuses indicate that the currency is becoming overvalued and the competitive position is deteriorating.

From 1973 to 1980 the percentage of countries where the competitive position was deteriorating each year varied from 43 per cent to 89 per cent. The percentage dropped sharply to 19 per cent in 1981, 11 per cent in 1982 and to perhaps only 7 per cent in 1983. As far as exchange rates are concerned, the adjustment process is working well. The adjustments, which started in 1981, contributed to the sharp drop in nominal LDC current account deficits (before official transfers) from some \$108 billion in 1981 to less than \$60 billion in 1983.

*e) Price Distortion and Real Growth*

The *World Development Report* of 1983 tells an interesting story of the impact of various price distortions on real economic growth. The message is very clear: the more the prices are distorted, the less the economic growth. And there is further evidence on the adverse impact of each of the various distortions in a major study by Anne Krueger and Vernon Ruttan of the University of Minnesota. Following are some pertinent quotes therefrom:

Moreover, efforts to increase agricultural production are often ineffective when prices received by farmers are held below world prices — due either to exchange rate overvaluation or to domestic programs to provide 'cheap' food to urban consumers.

Evidence accumulated over the period of the late 60's showed that countries which pursued reasonable foreign exchange and trade policies, did fairly well in international trade and did not face significant balance of payment difficulties.

No amount of foreign assistance can substitute for a developing country's internal policies and incentives for increasing output and improving the efficiency of resource allocation.

Setting the exchange rate 'right' is usually a pre-requisite for efficient resource allocation.

The policies under the control of countries are the critical issue. Aid helps, but it is not enough. And if the flow of bank funds is to be resumed, in a number of countries, more must be done.

Table 1  
Budget Balance as a Percentage of GDP (or GNP)

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983
ALGERIA	-10.90	4.20	0.30	1.33	0.19	0.11	-0.06	0.19	0.32	0.10*	—
ARGENTINA	-4.25	-5.20	-10.64	-7.16	-2.15	-3.24	-2.66	-3.59	-8.10	-6.90*	—
BRAZIL	—	—	—	—	—	-6.10	-8.10*	-7.10	-12.40	-15.20	-16.70
CHILE	-6.60	-5.10	0.10	1.20	-1.00	-0.11	4.82	5.63	3.20	1.50*	—
COLOMBIA	-2.34	-1.25	-0.22	1.02	0.63	0.68	0.55	-1.07	-0.07	-0.56*	—
COSTA RICA	—	—	-5.20	-6.50	-6.60	-9.00	-11.90	-13.90	-9.20*	—	—
ECUADOR	0.21	0.21	-0.51	-1.63	-3.24	-1.20	-0.65	-1.41*	-4.84	-4.50	—
GREECE	—	—	—	—	—	-1.70	-1.90	-4.40	-11.30	-7.50*	-8.70
HUNGARY	-0.42	-0.78	-0.60	-0.47	-0.60	-0.56	-0.53	-0.62	-1.22	-1.45*	-0.90
INDONESIA	-2.40	-1.55	-3.70	-4.40	-2.07	-3.30	-2.40	2.20	-3.00	-5.20*	-5.40
IVORY COAST	-2.40	-6.15	-2.80	-4.25	-1.30*	—	—	0.06	-1.08	—	—
JAMAICA	-5.50	-8.60	-11.00	-19.00	-17.00	-14.00	-12.00*	-16.88	-14.34	-15.60	-13.30
KENYA	-4.10	-2.70	-5.30	-5.40	-2.70	-2.10	-5.30	-2.10	-6.40	-6.60*	—
MALAYSIA	-6.14	-6.30	-10.97	-7.16	-8.91	-8.30	-8.34	-16.51	-25.64	-25.09*	-18.06
MEXICO	-7.00	-8.00	-12.00	-9.50	-7.10	-6.90	-7.30	-7.80	-14.70	-17.90*	-8.60
MOROCCO	-2.13	-4.02	-9.17	-17.61	-16.26	-10.43	-9.70	-10.43*	-16.60	-12.00	-8.70
PHILIPPINES	-1.17	0.40	-1.19	-1.77	-1.84	-1.22	-0.16	-1.28	-3.99*	-4.19	-2.15
POLAND	—	—	—	0.50	6.20	5.80	2.24	-1.40	-6.10	-1.70*	—
ROMANIA	—	0.61	0.45	0.73	0.24	0.23	0.07	0.24	0.99*	—	—
SOUTH KOREA	-1.40	-4.50	-4.90	-2.30	-2.70	-3.30	-2.00	-4.70	-5.80*	-4.36	3.00
THAILAND	-3.25	-0.92	-2.09	-4.11	-3.35	-3.83	-3.75	-4.69	-3.50*	-5.90	-3.80
TURKEY	—	—	—	—	—	—	-8.60	-10.00	-6.50*	-5.50	-4.50
VENEZUELA	1.54	2.33	0.40	-4.26	-6.45	-6.97	0.47	-0.70	-2.64*	-3.80	-1.30

\* Latest Actual, thereafter estimated or projected by IIF.

Average :	-3.4	-2.6	-4.2	-4.5	-3.8	-3.6	-3.5	-4.4	-6.7	-7.1	-6.9
% Negative :	88	72	79	75	80	81	77	78	87	90	92

Source : Institute of International Finance.

Table 2  
Total Claims of Local Monetary Sector  
On Economy  
Percentage Change

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983
ALGERIA	25.57	8.53	41.26	26.92	18.30	40.43	13.19	17.24	11.96*	—	—
ARGENTINA	83.00	64.00	167.00	244.10	233.30	105.30	203.20	111.30	209.30	224.10*	—
BRAZIL	50.00	51.00	57.00	64.00	57.00	36.00	84.00	74.00	60.00	129.00*	147.00
CHILE	630.00	449.00	413.10	152.60	130.60	60.90	47.40	47.20	30.30	74.50*	—
COLOMBIA	20.70	42.00	32.70	19.40	29.60	2.40	5.90	44.00	37.00	42.00*	—
COSTARICA	9.70	49.40	45.20	18.00	30.90	30.20	43.50	24.30*	10.30	5.00	9.70
ECUADOR	7.80	43.00	22.90	23.30	21.00	11.00	37.30	27.40	30.50	38.80*	—
GREECE	22.00	23.00	25.00	27.20	26.30	22.90	21.40	21.90	34.60	26.90*	17.50
HUNGARY	—	—	—	28.52	14.18	16.29	9.80	8.21	8.86	6.09*	4.60
INDONESIA	—	34.26	95.81	18.57	6.22	38.19	4.43	-2.92	35.57	50.04*	—
IVORY COAST	22.00	37.00	30.00	38.50	42.90	11.10	15.30	23.10	23.00	7.00*	—
JAMAICA	16.20	8.70	42.40	27.00	11.80	28.70	45.60	4.90	43.30	21.30*	19.20
KENYA	27.90	28.70	29.20	16.50	23.00	35.80	14.20	13.10	26.90	29.70*	—
MALAYSIA	49.29	21.20	18.49	16.47	18.32	24.16	40.27	60.44	33.53	22.97*	22.74
MEXICO	34.30	43.00	27.00	21.00	142.10	31.20	34.90	38.70	49.50	113.00*	37.00
MOROCCO	16.53	29.26	23.45	20.37	22.03	23.72	13.26	14.68	16.19	5.32*	—
PHILIPPINES	13.00	40.20	31.30	26.80	20.03	24.30	25.20	21.70	23.30	23.60*	—
POLAND	—	—	—	—	—	-37.38	-23.88	0.98	-15.53*	—	—
ROMANIA	—	24.10	9.70	17.00	6.00	15.20	6.10	9.90	0.00	9.30*	—
SOUTH KOREA	29.60	52.60	31.50	23.70	24.00	45.40	35.70	40.60	31.10	25.10*	—
THAILAND	28.81	19.25	25.69	20.06	28.56	28.35	20.63	18.15	17.73	21.50*	11.05
TURKEY	22.60	39.10	51.00	41.60	41.20	33.90	59.60	83.70	49.10	46.20*	—
VENEZUELA	18.50	-78.00	107.02	205.00	66.32	49.87	4.42	20.53	22.38*	—	—

\* Latest Actual, thereafter estimated or projected by the IIF.

Average :	59.3	49.0	63.2	49.9	46.1	33.0	31.8	32.0	34.6	44.9	33.6
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Source : Institute of International Finance.

Table 3  
Consumer Price Index  
Percentage Change

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983
ALGERIA	6.00	4.00	9.00	8.00	12.00	17.00	11.00	9.00	14.60	7.00*	8.00
ARGENTINA	60.30	24.20	182.50	443.20	176.10	175.50	159.50	100.80	104.50	165.00	344.00*
BRAZIL	12.70	27.60	28.90	42.00	43.00	38.00	53.00	83.00	105.50	98.00*	142.00
CHILE	100.00	600.00	374.70	211.79	91.95	40.09	33.39	35.14	19.69	9.94	27.00*
COLOMBIA	20.70	24.30	22.90	20.20	33.00	17.80	24.90	26.50	27.50*	24.60	20.00
COSTA RICA	15.30	30.20	17.30	3.50	4.10	6.00	9.30	18.10	37.10	89.80*	33.00
ECUADOR	13.00	23.20	14.50	11.60	13.10	14.00	10.30	13.90	12.00	16.30*	—
GREECE	15.50	26.90	13.50	13.20	12.20	12.50	19.00	24.00	24.50	21.70*	20.50
HUNGARY	3.40	1.70	3.80	5.00	4.00	4.50	9.00	9.10	4.60	6.90*	8.00
INDONESIA	31.14	40.47	19.06	19.79	11.11	8.11	21.90	18.53	12.24	9.48*	13.00
IVORY COAST	11.32	17.50	11.40	12.10	27.40	13.00	16.60	14.70	8.80	7.30*	8.00
JAMAICA	17.70	27.20	17.40	9.90	11.50	35.00	28.80	27.00	12.50	6.00*	7.00
KENYA	9.00	18.10	19.00	11.40	14.90	17.00	8.00	13.80	11.80	20.50*	—
MALAYSIA	10.47	17.43	4.43	2.62	4.74	4.99	3.54	6.72	9.70	5.83*	4.00
MEXICO	12.10	23.50	15.40	15.70	29.00	17.50	18.20	26.40	27.90	58.90*	90.00
MOROCCO	2.70	17.50	7.90	8.50	12.60	9.70	8.40	9.40	12.50	10.60*	10.10
PHILIPPINES	13.90	33.70	8.00	6.20	8.00	7.50	18.90	17.80	13.30	10.90*	10.00
POLAND	2.80	7.10	3.00	4.40	4.90	8.10	6.70	9.10	24.40	100.20*	—
ROMANIA	—	1.10	0.20	0.50	0.60	2.00	1.80	1.50	1.80	16.00*	—
SOUTH KOREA	3.20	24.30	25.30	15.30	10.20	14.50	18.30	28.70	21.30	7.30*	3.50
THAILAND	15.38	24.38	5.36	4.13	7.63	7.80	10.00	19.62	12.70	5.24*	3.90
TURKEY	13.93	23.89	21.22	17.43	25.99	61.93	63.53	94.25	37.61	32.67*	30.00
VENEZUELA	4.20	8.30	10.10	7.60	7.90	7.00	12.40	21.50	16.20	9.90*	7.00

\*Latest Actual, thereafter estimated or projected by the IIF.

Average : 17.9 45.5 36.3 38.9 24.6 23.5 24.6 27.4 24.9 32.2 41.5

Source : Institute of International Finance.

**Table 4**  
**Real Short-Term Interest Rate (Average)**  
**In Percent**

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983
ALGERIA	—	—	—	—	—	—	—	—	—	—	—
ARGENTINA	-25.00	-1.80	-48.70	-73.00	21.70	-11.80	-18.00	7.10	69.70	71.83*	14.86
BRAZIL	0.90	-9.20	-8.40	-8.30	-7.90	-3.10	-13.33	-27.00	-23.00	-15.35*	-26.41
CHILE	—	—	—	—	—	16.21	8.78	1.02	17.64	34.44*	8.00
COLOMBIA	-5.60	-6.70	-5.60	-0.20	-9.80	3.60	4.10	2.80	2.00	2.00*	—
COSTA RICA	-8.90	-17.80	-8.80	4.30	3.70	1.90	-1.20	—	—	-31.50*	-2.25
ECUADOR	-4.40	-12.30	-5.70	-3.20	-4.50	-5.30	-2.10	-5.20	-3.60	-7.10*	—
GREECE	-5.60	-14.90	-3.10	-2.80	-1.10	1.30	0.00	-3.40	-3.20	-0.40*	0.00
HUNGARY	4.45	6.19	5.01	3.01	4.81	4.31	0.00	-0.10	6.12	6.64*	5.09
INDONESIA	—	—	—	—	-3.40	-0.50	-10.00	-7.10	-1.20	2.70*	2.00
IVORY COAST	-5.04	-10.14	-3.05	-3.65	-15.23	-4.42	-7.38	-3.66	1.56	4.84*	—
JAMAICA	-10.30	-15.70	-8.90	-2.50	-3.90	-19.80	-15.20	-13.50	-2.40	1.70*	5.14
KENYA	—	—	—	—	—	—	—	—	—	—	—
MALAYSIA	-4.50	-9.30	1.30	3.10	0.20	0.00	1.90	1.70	0.30*	3.50	3.60
MEXICO	-3.22	-10.91	-3.38	-3.85	-12.70	-4.04	-0.26	1.05	4.17	-0.92*	-2.63
MOROCCO	—	—	—	—	—	—	—	—	—	—	—
PHILIPPINES	—	-12.06	6.49	6.35	4.24	3.00	-5.05	-3.83	2.03	2.98*	5.91
POLAND	—	—	—	—	—	—	—	—	—	—	—
ROMANIA	—	—	—	—	—	—	—	—	—	—	—
SOUTH KOREA	—	—	-8.20	0.80	5.40	-0.10	0.30	-3.70	-1.50	7.20*	11.00
THAILAND	-5.27	-10.52	5.07	3.43	1.57	3.90	4.33	-4.15	4.04	9.23*	9.00
TURKEY	-4.60	-12.02	-10.08	-7.18	-13.50	-32.07	-32.20	-35.14	-4.44*	—	—
VENEZUELA	5.60	1.80	0.00	1.00	1.50	2.80	-0.60	-7.00	-1.20	5.90*	8.60

\*Latest Actual, thereafter estimated or projected by the IIF.

Average	-5.1	-9.0	-6.0	-5.1	-1.7	-2.5	-4.8	-5.9	3.9	5.7	3.0
% Negative :	79	87	69	56	53	50	61	71	47	29	21

Source : Institute of International Finance.

**Table 5**  
**Selected Developing Countries : Interest Rates and Inflation**  
**June 1978 – June 1981**

	June 1980 Interest Rate <sup>1</sup>	June 1980-June, 1981 Percentage Change in the Consu- mer Price Index	June 1980 Interest Rate Adjusted for Inflation <sup>2</sup>	June 1979 Interest Rate Adjusted for Inflation <sup>3</sup>	June 1978 Interest Rate Adjusted for Inflation <sup>3</sup>
Argentina <sup>4</sup>	107.8	94.3	6.9	-3.8	-17.1
Bahrain	9.0	6.1	2.7	1.2	7.6
Bangladesh	8.2	14.2	-5.2	-3.6	-5.3
Brazil <sup>5</sup>	73.2	106.3	-16.0	-13.1	-0.4
Burma <sup>6</sup>	8.0	-3.7	12.1	5.4	3.7
Chile <sup>4</sup>	37.9	21.0	14.0	13.1	18.2
Colombia <sup>7</sup>	35.4	27.9	5.9	-4.5	0.0
Ecuador	12.0	18.0	-5.1	0.4	0.3
Egypt	9.0	11.9	-2.6	-14.1	0.5
Ghana	13.0	118.2	-48.2	-19.6	-36.4
Greece	16.0	23.3	-5.9	-11.8	-3.6
India	7.0	13.7	-5.9	-4.4	0.5
Indonesia	9.0	9.0	0.0	-7.9	-12.4
Ivory Coast	7.2	2.5	4.6	-8.3	-10.2
Jamaica	9.0	11.5	2.2	-15.9	-15.1
Kenya	6.3	11.8	-4.9	-7.1	-1.7
Korea	23.0	25.6	-1.3	-6.2	-0.8
Kuwait <sup>8</sup>	9.2	6.8	2.2	-2.1	1.5
Malaysia	7.0	11.2	-3.1	-0.1	3.7
Mexico <sup>9</sup>	15.6	27.8	-9.5	-8.7	-2.4
Morocco	7.0	15.2	-7.1	-2.5	-0.7
Nepal	12.0	13.8	-1.6	-2.9	4.7
Nigeria	6.3	24.2	14.4	-4.2 <sup>1</sup>	-3.1 <sup>10</sup>
Pakistan	12.0	15.0	-2.6	0.7	2.5
Peru	35.5	81.5	-25.3	-13.8	-27.9
Philippines	12.0	11.1	0.8	-6.0	-8.6
Portugal	21.0	17.6	2.9	3.7	-2.6
Singapore <sup>9</sup>	10.3	8.7	1.5	-3.4	2.4
South Africa	7.5	14.5	-6.1	-6.1	-3.5
Sri Lanka	20.0	17.0	2.6	-12.3	6.9
Syrian Arab Republic	5.0	15.1	-8.8	-13.1	1.2
Thailand	12.0	11.6	0.4	-12.0	1.0
Turkey	33.0	28.9	3.2	-47.0	-28.3
Uruguay <sup>11</sup>	51.2	34.8	12.2	-13.8	-10.1
Venezuela	12.0	17.7	-4.8	-8.8	-2.2
Zaire	25.0	25.8	-0.6	-18.0	-51.4
Zambia	8.3	13.0	-4.2	-4.9	-2.0

<sup>1</sup>Unless otherwise indicated, the rate on one-year time deposits that would have been earned over the 12 months subsequent to June 1980.

<sup>2</sup>Computed as  $100 [(1+i)/(1+p)-1]$ , where  $i$  is the nominal interest rate,  $p$  is the change in the consumer price index over the previous 12 months and both are expressed in decimal form.

<sup>3</sup>Computed in the same way as the rate for June 1980.

<sup>4</sup>The interest rate is the yield on one-month time deposits compounded over the relevant 12-month period. Longer-term rates are unimportant because of the dominance of shorter-term rates.

<sup>5</sup>The interest rate is the yield on two-year treasury bonds acquired 12 months before the indicated month, including interest and monetary correction.

<sup>6</sup>The interest rate on savings bank accounts is used because of the unimportance of time deposits.

<sup>7</sup>For the 1980 interest rate, the rate on 90-day certificates of deposit is used, compounded over the appropriate period.

<sup>8</sup>Data taken from *International Reports Statistical Market Letter*, various issues.

<sup>9</sup>Data for June 1980 only taken from *International Reports Statistical Market Letter*, various issues.

<sup>10</sup>Twelve-month time deposit rate in effect was 5.25 percent.

<sup>11</sup>The interest rate is the yield on six-month time deposits compounded over the appropriate period.

Source : IMF Occasional Paper 22, "Interest Rate Policies in Developing Countries," October, 1983.

Table 6  
Competitive Position  
Percentage Change

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983
ALGERIA	—	28.16	2.69	-8.40	-14.00	-15.24	18.34	-15.42	3.38	3.02*	—
ARGENTINA	7.00	-45.60	49.70	-20.30	19.90	-18.80	-28.50	-23.80	27.40	148.71*	—
BRAZIL	-9.80	-8.50	-3.00	-5.10	-1.50	-2.90	3.40	9.90	-8.90	4.52	18.44*
CHILE	—	-25.90	27.00	-17.50	-12.50	12.70	-12.60	-11.10	-3.30	23.60*	38.68
COLOMBIA	-6.50	-5.75	7.14	-4.47	-12.49	-2.53	-4.74	-5.16	1.35*	0.92	5.02
COSTA RICA	-7.80	5.10	-5.10	-9.70	-9.60	-0.50	-0.40	-8.00	91.96	-6.09*	-13.50
ECUADOR	-0.55	-22.20	-0.70	-6.00	-10.00	-0.50	-6.60	-8.50	-3.30	9.55*	—
GREECE	-12.50	-8.90	4.80	3.10	-5.60	-5.10	-7.60	6.80	18.50	2.00*	12.20
HUNGARY	-8.80	5.10	1.80	-6.00	2.00	-4.00	-3.40	-5.10	9.40	7.40*	13.30
INDONESIA	-20.50	-26.10	-2.00	-8.10	-6.40	3.20	15.60	-14.90	0.40*	2.70	12.60
IVORY COAST	-3.70	-6.80	1.80	-9.70	-18.30	3.31	2.80	0.00	6.40*	—	—
JAMAICA	1.04	-16.66	-9.90	-5.10	-5.40	35.20	14.50	-5.80	1.70	-1.50*	1.00
KENYA	-4.50	-4.70	-3.50	3.80	-10.40	-2.70	-1.30	-3.10	24.30*	—	—
MALAYSIA	-22.40	-4.50	12.10	-1.10	-4.20	-3.70	-9.70	1.00	12.40*	5.70	—
MEXICO	-6.50	-11.40	-5.50	8.80	18.70	-7.30	-9.50	-14.60	-8.30	50.60*	14.50
MOROCCO	-10.58	-1.56	-2.72	9.10	-5.80	-7.25	-5.62	2.07*	28.63	2.05	6.61
PHILIPPINES	-9.10	-16.81	8.60	-1.80	-2.24	-2.30	-5.92	-3.19	4.40	6.10*	15.70
POLAND	—	—	—	—	—	—	—	—	—	—	—
ROMANIA	—	—	—	—	—	—	—	—	—	—	—
SOUTH KOREA	-5.21	-15.80	6.36	-10.82	-9.20	-10.98	-8.72	9.73	5.74	5.38*	5.45
THAILAND	-12.74	-10.31	7.25	1.33	-2.60	-1.40	-2.20	-6.12	7.95	6.63*	1.40
TURKEY	-13.82	-16.50	-2.40	-0.45	-1.53	-4.73	-16.42	31.29	12.76	21.43*	12.50
VENEZUELA	-7.68	-24.93	10.13	-0.28	-1.78	1.07	-10.97	-11.69	-3.36*	3.74	—

\* Latest Actual, thereafter estimated or projected by the IIF.

Average :	-8.1	-11.2	4.9	-4.3	-4.5	-1.6	-3.8	-3.6	10.9	15.6	10.3
% Negative :	89	86	43	76	86	76	76	67	19	11	7

Source : Institute of International Finance.

## *A Comment*

George J. Vojta

In the six months following the September 1983 meeting of this Roundtable, some progress was made in managing the international debt crisis.

1. Energy prices remained stable.
2. The economic recovery continued on a non-inflationary course in the developed economies. Although economic activity in the developing economies remained relatively unaffected, the growth trends were in the right direction. As an offset, some commodity prices weakened during this period.
3. The most difficult debt restructuring case — Brazil — was accomplished, and a policy program was agreed to by Brazil with the Fund. Except for Venezuela, Nigeria and the Philippines, the major debtors have established stabilization programs with the IMF. Venezuela remains a difficult case, but the perception of the lending community is that Venezuela has the capacity to service its external debt and that the Philippines will come to terms with the Fund. Nigeria's situation remains uncertain in view of the recent change in government. The new government in Argentina has assumed a constructive posture vis-a-vis the policy commitments made by the military government to the International Monetary Fund, although currently there are arrearages in payments.

The principal causes of the debt crisis — high energy prices, the global recession, and the absence of appropriate stabilization programs in individual countries — continued on a turnaround trend.

On the negative side, system-wide financial flows remain perverse. The continuing U.S. fiscal deficits, the overvalued dollar, high interest rates and political instability in certain Third World countries resulted in a continued strong net capital inflow into the United States and other developed economies. According to recent data, net foreign investment in the U.S. for the year ending September 30, 1983 amounted to \$49 billion; total foreign holdings in the U.S. amounted to \$711.4 billion compared with \$834.2 billion of total U.S. holdings abroad. If this trend continues, the U.S. stands to become a net international debtor, which would mean that the

U.S. net foreign investment position built gradually over the post war period would have been reversed in a three-year period, from 1983 to 1985. Although the value of the U.S. dollar has declined by roughly 3 per cent in recent months, the basic trend has yet to be reversed.

During this period, calls for fundamental reform in the international financial system abated and the international community committed itself *de facto* to working within the system to resolve the debt crisis. Undoubtedly this is not by choice, but arises from the absence of a visible alternative.

On specific issues, both positive and negative developments in the recent period can be recorded.

1. The decline of the number of banking institutions willing to continue international lending probably has bottomed out, and thus far it has been possible to put loan syndicates together, although the new Mexican loan facility was difficult to place. On the other hand, no progress has been made in introducing any new class of lending institution into the international credit picture. The best that can be said, then, is that the reduced lending base is holding and is at this point keeping up with the demand. An encouraging sign, however, is that the Third World borrowers, now negotiating for new money, are closing these transactions on better rates and terms.

2. Many banks are working diligently on the issue of potential secondary market activities involving international loans. Initiatives include changing loan documentation to permit placement of loans in the secondary market, active portfolio swap or sale transactions offered in the marketplace, and serious study of the question in both the commercial and investment banking fraternities. It is fair to say that a major effort is under way.

3. The Institute of International Finance is functioning with the support of the international financial community and borrowing countries. It is still too early to assess performance, but it is an encouraging sign that this potentially vital institution has been launched.

4. There have been no new initiatives taken by multilateral or official institutions at the national level with respect to lending or guarantor functions, secondary market activity or uses of market funds to augment resources.

5. One of the most important steps forward during this period was the U.S. congressional approval of higher United States quotas

for the Fund and approval of the IDA quota, although at less than the desired level. Importantly, the trade-off on reserve requirements levied on American banks against their international loan portfolio was nonpunitive — requiring stipulated write-offs of from 10 to 75 per cent against loans outstanding to five particular countries (Zaire, Poland, Sudan, Bolivia, Nicaragua), most of which the banks had taken already. A similar pattern emerged in other major countries.

The regulatory community appears committed to policies which would require the banks to build up “restructuring” or “concentration” reserves over a period of time, and there will undoubtedly be active discussion of this issue during 1984. On the whole, this matter is being considered in a more balanced fashion.

The important point is that the IMF quotas were voted and the banks permitted to continue lending without incurring punitive regulatory sanctions.

6. Although a formal review of more flexible conditionality standards has yet to occur, it appears that the Fund is showing flexibility in bilateral negotiations with member countries concerning future performance targets; it is showing a willingness to expand targets to permit more latitude for anti-recessionary domestic policies.

7. No particular progress has been made on the creation of a new institution to promote international debt restructurings nor on the issue of universality of membership in the Fund/Bank.

In sum, over the last six months, positive movement was achieved in several practical areas, and reversals were avoided or neutral positions recorded in several others. This occurred in the context of continuing global recovery from the recession, stability in energy prices, improving individual country performance, offset by the perversity of the international capital account flows, the persistence of high interest rates and an overvalued dollar.

The focus of attention in the next several months must be on three priority issues.

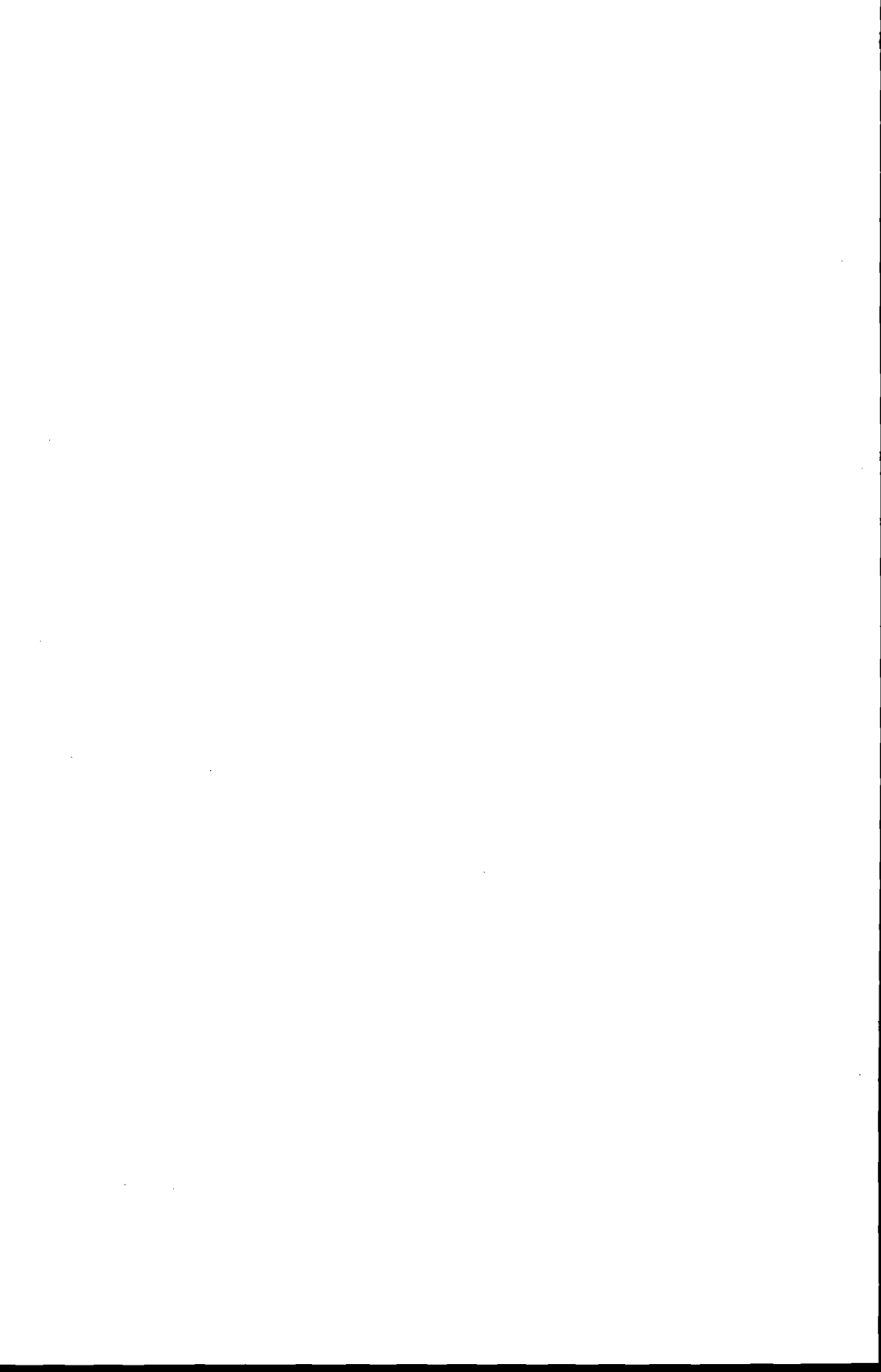
1. At the macro-level, the situation of perverse capital flows, stemming from the overvalued dollar and high interest rates which threaten to abort the global recovery, must be corrected. The prognosis for this is not good, however, since the root cause of the problems are the uncorrected U.S. fiscal deficits. In an election year, the prospects for significant spending reductions in the U.S.

are not great. The great danger is the erosion of confidence in the U.S. dollar, which would arise from market perceptions that U.S. deficits will reach unsustainable levels and lead to a renewal of inflation. A bipartisan political commitment to a deficit reduction program over time would be helpful to stabilize the market psychology.

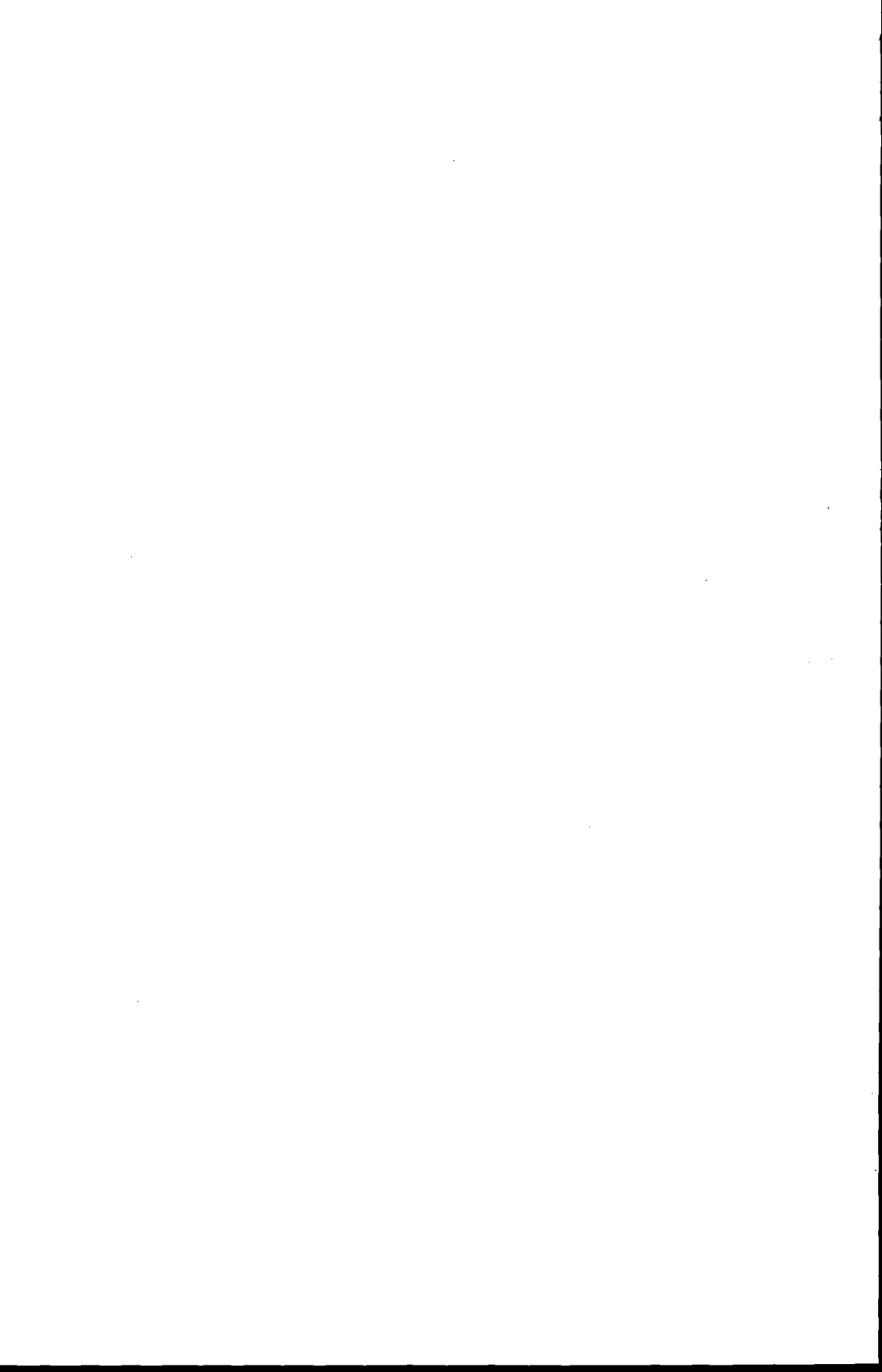
2. The remaining debt restructuring cases must be completed, and acceptable levels of new money to meet 1984/85 requirements must be negotiated, to prevent the emergence of arrearages which would require punitive measures to be taken by the banking system. This will involve persistent effort by the international financial community, consistent with the effort expended during the crisis period.

3. The IMF needs to maintain its flexible attitude toward compliance targets, in support of expansionary policies which do not create excessively inflationary conditions in borrowing countries. An enlightened debate on conditionality should be conducted.

4. The work to build a secondary market function for international loans must continue.



## **APPENDICES**



## Appendix A

### *Santiago Statement*

The Santiago Roundtable met in the midst of an ongoing debate on whether the threat of a worldwide financial crisis has been successfully overcome or merely postponed.

It is clear that while substantial progress has been achieved without any of the feared debt repudiations, "adjustment" has been secured at great human costs in some cases, and the potential threat of a financial crisis has not entirely disappeared.

The world economic recovery is still fragile. The debt problem has been postponed, but with present obligations delayed at the price of higher payments in the future. The cost of adjustment for developing countries has been especially high in terms of lost output, depressed employment and rising poverty levels. Unemployment rates have reached over 30 per cent in some countries, with cuts in real wages of as much as one-third and declining per capita incomes in more than half of the developing countries. These indices reflect costs of adjustment thus far. The industrialized nations share similar costs in terms of their own depressed output and employment levels. The world still awaits the kind of adjustment process that would strengthen global economic recovery and reduce the cost of adjustment for each nation.

It is in this context that the Santiago Roundtable considered the overall scope, precise nature and specific instruments of successful adjustment and reached some broad conclusions.

#### **Nature of the Adjustment Process**

Successful adjustment involves the achievement of a satisfactory level and growth of a country's internal activity as well as external balance. While restoration of a viable external balance is extremely important, it is not desirable to seek it at sharply reduced levels of domestic output and employment. Adjustment should become synonymous not with policies of austerity but with policies aimed at resuming prosperity.

It is necessary, therefore, that policy measures for adjustment should be expansionary, not contractionary. Export expansion must be preferred over import curtailment. Large investment in increasing supplies must accompany any short-term demand management. Human resource development should not be sacrificed for short lived gains in material production. It is equally necessary that the adjustment process should be global in its scope so that expansionary policies of some countries are not frustrated by the deflationary policies of others.

All parties must share responsibility for the current financial and economic crisis and the burden of adjustment. The burden which today is being borne largely by the developing countries must be shouldered too by industrialized countries, by the private banking system and by multilateral financial institutions. We must move to a more mature stage in the evolution of our thinking, where "adjustment process" no longer has a nasty sting and "conditionality" is no longer pejorative. Accepting this perspective frees the current dialogue from heated polemics and guides it into the more productive channel of exploring practical proposals.

### **Conditionality**

The need for adjustment in many countries is a domestic necessity, not just an imposition of the international community. Each country in need of adjustment should formulate its own package of measures — taking into account external realities and domestic social objectives — to restore a sustainable balance-of-payments, maintain high levels of output and employment, and protect fully its human resource development. The role of international institutions is to help develop effective programs and to ensure that individual programs are mutually compatible. If countries cannot reach agreement with external financiers once these packages have been formulated, this would give genuine cause for international concern and establish the need for change in the conditionality. At the moment, many countries have not developed viable and well-formulated alternatives.

It was agreed in the Santiago Roundtable that the conditionality of the IMF (and other lending institutions) should be linked not only to monetary and financial measures but also to levels of output and

employment and to a set of physical quality-of-life indices.

Mechanisms must also be devised to enable the IMF (and other institutions) to secure adjustment by surplus countries, thereby reducing the present disproportionate burden on deficit countries, and also to fulfill its major responsibility: "to facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and the development of the productive resources of all members as primary objectives of economic policy." (IMF Articles of Agreement 1(ii))

### **Finance and Adjustment**

Adjustment that involves expansion of exports and import substitution capacity, rather than relying exclusively on restriction of demand, necessarily takes some time to implement and requires supporting flows of medium-term finance. Moreover, to keep austerity within the limits of political and social tolerance, it is essential that external finance be increased substantially, not as a substitute for domestic policy changes (including mobilization of domestic saving as the major source of investment finance) but to assist in engineering structural and other adjustments needed to restore external balance at a high level of domestic activity.

In this spirit, the Roundtable considered a number of practical proposals.

### **A Larger IMF**

The IMF needs substantially larger resources in order to play a more active role in the adjustment process, and to give countries more breathing space to adjust their policies in an expansionary fashion. The current IMF resource constraints are partly responsible for short adjustment periods and therefore for deflationary policies via demand restraint, since sufficient medium-term finance to permit emphasis on supply expansion is not available. Seeking external balance at high levels of domestic activity will thus require a substantial increase in the present resources of the IMF — perhaps to twice as much as the present level. This expansion should be accompanied by developments in conditionality and adjustment programs as proposed above. Since there is an inevitable time lag between ideas

and their implementation, it is recommended that the necessary professional analysis and intellectual preparation for such an increase in Fund resources and in its role should be started without delay.

### **An SDR Allocation**

The reserves of many countries are now inadequate. The reserve/import ratio of capital-importing developing countries has fallen from 39 per cent in 1972 to 25 per cent in 1983. The inadequacy of reserves is one factor impeding the reestablishment of credit-worthiness, adding to import costs and perpetuating the pressures for excessive deflation of demand in many debtor countries. It would be better for all countries involved if a significant part of the required reserve-building were to be accomplished immediately, without the necessity for corresponding real resource transfers or additional international borrowing. This objective could be achieved by a substantial SDR allocation. There is a strong case for such an allocation in the present circumstances, when inflationary pressures have eased, international liquidity has shrunk, and capital-importing developing countries require immediate addition to their reserve assets, without having to choose between an unacceptably high political and social price for it and continued excessive vulnerability to illiquidity.

It is recommended that a substantial proportion of this expanded global need for non-inflationary liquidity be met in the next few years through additional allocations of SDRs. Assuming a world trade expansion of 4 per cent a year and a corresponding expansion in the need for international reserves, an annual increase of roughly SDR 16 billion could be accommodated without inflationary consequences. It is proposed that annual allocations should be at least 10 per cent of present Fund quotas, with provision for some front end loading, so that developing countries can have access to a limited amount of nonconditional liquidity besides the conditional reserves of the Fund.

### **IDA Supplementary Facility**

The failure to negotiate IDA replenishment of a size that was recognized as necessary by all donors, with the exception of one

country, will have a serious adverse impact on the prospects of low-income countries. The amount negotiated in January 1984 is in real terms about half of that attained in the sixth replenishment period, and comes at a time when the population of IDA recipient countries has nearly doubled with the inclusion of China. Hence it is suggested that a special fund be created with an initial size of \$2.25 billion (in line with the suggestions of the IDA deputies) in parallel to IDA.

### The Debt Issue

This issue is in one sense a reflection of the world recession and of unprecedented high interest rates. As a result of these developments, debt servicing resulting from lending and borrowing in the 1970s proved difficult to handle in the 1980s. Floating rates of interest on existing debt have played a major part in the increasing debt burden.

The present debt problem is literally feeding on itself. More is being borrowed to pay interest on past debt, and this, in turn, is continuing to support high interest rates. From the point of view of all concerned, there is an urgent need to reach a solution which is fair to all parties and which is in the interests of the world economy.

While the present *ad hoc* country-by-country rescheduling has been helpful, it does not attempt to deal with the basic issues and can raise the total cost of the debt by adding another uncertainty. An agreed solution, negotiated between countries (developed and developing) and banks is still needed. Repudiation and default are not part of any constructive solution.

Thus the following should be considered:

- (i) proposals to secure a world-wide reduction in interest rates;
- (ii) schemes for interest payment stabilization, resulting in variable maturity dates;
- (iii) a scheme which limits total debt servicing of developing countries to a percentage of their export earnings or GNP.

In this context, the Santiago Roundtable referred to the relevant proposals in the Quito Plan of Action approved by the Latin American Economic Conference in January 1984.

## Appendix B

### Participants\*

DRAGOSLAV AVRAMOVIC

Former Special Adviser on Economic Cooperation,  
United Nations Conference on Trade and Development (UNCTAD)

ARTHUR BROWN

Associate Administrator, United Nations Development Programme  
(UNDP)

SHAHID J. BURKI

Director, International Relations Department, The World Bank

BERNARD CHIDZERO

Minister of Finance, Economic Planning and Development, Zimbabwe  
Represented by TIMOTHY R. MUZONDO

GEORGE J. CLARK

Executive Vice President, Citibank/N.A.

ANDRES CONCHA

Director, Direccion General de Relaciones Economicas Internacion-  
ales, Ministerio de Relaciones Exteriores, Chile

GAMANI COREA

Secretary General, UNCTAD

SIDNEY DELL

Executive Director, Center on Transnational Corporations, United  
Nations

ANDRE DE LATTRE

Managing Director, Institute of International Finance

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\* *Participants attended in their personal capacities.*

**RICHARD FEINBERG**

Vice President, Overseas Development Council

**RICHARD FLETCHER**

Deputy Manager for Integration and International Economics,  
Inter-American Development Bank

**IRVING S. FRIEDMAN**

Senior International Adviser, First Boston Corporation

**FRANCISCO GARCES**

Director Internacional, Banco Central de Chile

**MAHBUB UL HAQ**

Minister of Planning and Development, Pakistan

**DAVID IBARRA**

Former Minister of Finance of Mexico

**ENRIQUE V. IGLESIAS**

Executive Secretary, Economic Commission for Latin America  
(ECLA)

**UNER KIRDAR**

Director, Division of External Relations, UNDP

**CARLOS GERALDO LANGONI**

Former Governor, Central Bank of Brazil

**ALBERTO LUZARRAGA**

Executive Vice President, American Express International Banking  
Corporation

**RODRIGO LLORENTE**

Former Minister of Finance of Colombia

**GABRIEL MARTINEZ**

Economist, Ambassador of Argentina

**CARLOS MASSAD**

Special Adviser, ECLA and Professor, University of Santiago de Chile

**AZIZALI F. MOHAMMED**

Director, Office of External Relations,  
International Monetary Fund (IMF)

**JAIME MONCAYO**

Former Minister of Finance of Ecuador

**ARTURO O'CONNELL**

Economic Adviser to the President of Argentina

**MARIA ELENA OVALLE**

Gerente General , Asociacion de Bancos e Instituciones Financieras  
de Chile

**FELIX PENA**

Consultant, Organization of American States (OAS)

**SHIRDATH RAMPHAL**

Secretary General, Commonwealth Secretariat  
Represented by VISHNU PERSAUD

**JOSEPH RAMOS**

Senior Economist, Economic Development Division, ECLA

**GUSTAV RANIS**

Professor of International Economics, Department of Economics,  
Economic Growth Center, Yale University

**FRANCISCO RECABARREN**

Director, Direccion, de Asuntos Economicos Multilaterales,  
Ministerio de Relaciones Exteriores, Chile

**WOLFGANG RIEKE**

Director General, International Monetary Affairs and International  
Organizations, Deutsche Bundesbank

JEAN RIPERT

Director General for Development and International Economic  
Cooperation, United Nations

Represented by HUGO CUBILLOS

A. SANGOWAWA

Director, African Development Bank

FRANCES STEWART

Senior Fellow, Institute of Commonwealth Studies, Oxford University

MAURICE F. STRONG

Chairman, Canada Development Investment Corporation

ROY TAKATA, JR.

Executive Director, International Lending, Bank of Tokyo

MIGUEL URRUTIA

Vice Rector, Development Studies Division, United Nations University

GEORGE VOJTA

President, Deak & Company, Inc.

JOHN WILLIAMSON

Senior Fellow, Institute for International Economics

ISRAEL WONSEWER

Professor, University of Montevideo, Uruguay

MASAHARU YOSHITOMI

Chief Economist, Research Institute of the Economic Planning  
Agency of Japan

JORGE YARUR

President, Asociacion de Bancos e Instituciones Financieras de Chile

ROBERTO ZAHLER

Expert, ECLA/UNDP Project on Monetary and Financial Problems,  
ECLA

**Observers**

**EDUARDO FERNANDEZ ESPINAR**

Resident Representative, UNDP, Santiago

**CHRISTIAN OSSA**

Chief of Branch, International Economics Relations Branch,  
United Nations

**DAVID H. POLLOCK**

Consultant, ECLA and Professor of International Affairs,  
Carleton University, Ottawa

**Conference Coordinators**

**KHADIJA HAQ**

Executive Director, North South Roundtable

**CARLOS MASSAD**

Special Adviser, ECLA

## Appendix C

### *About the North South Roundtable*

The North South Roundtable, established in 1978 under the auspices of the Society for International Development, is an independent intellectual forum in which academics, researchers and policy makers from around the world come together to discuss global development issues. The Roundtable brings together experts from every continent in many fields, all sharing a commitment to orderly progress in human affairs, for the advancement of a constructive dialogue between North and South, developed and developing, rich and poor nations, in search of a more just and stable world order.

The Roundtable serves as a sounding board for the expression of new ideas, as a monitor for the North-South negotiations under way in official bodies, as a private channel for the unencumbered exploration of possibilities for consensus, as a public educator on global development issues, and as an informal meeting ground on which key policy makers in public and private life appear in a personal capacity. In annual sessions involving the whole membership of over 150 and in smaller sessions convened for the discussion of specific development issues, the North South Roundtable seeks to identify and analyze the most significant issues and to develop policy proposals in the mutual interest of North and South. The ideas evolved in the Roundtable process are disseminated to the general public, national decision makers and other international organizations, through Roundtable publications and through direct briefings.

The North South Roundtable is founded on a recognition of the ever increasing interdependence — economic, political, and social — of the diverse nations and regions of the world and is guided by a vision of world justice and world community. The Roundtable places hope in the process of North-South Dialogue, for the discovery of new national policies and international structures in the interest of both developed and developing countries.

## Ongoing Programs

*The North South Energy Roundtable.* The North South Energy Roundtable is an international task force for the preparation of policy studies on the future of energy and a forum for dialogue on energy issues. The Energy Roundtable works to put energy in its proper international developmental perspective and to ensure policy makers' access to accurate analysis and data. The Energy Dialogue Missions of the North South Energy Roundtable visit developing countries, developed nations and international fora, to gather and relay information on national, regional and international energy policies and needs and to establish a dialogue with high-level policy makers within and among nations.

*The North South Food Roundtable.* The focus of the North South Food Roundtable is worldwide food security for nations and people. In meetings of experts in the food area, in briefings and in publications, the North South Food Roundtable works to assess the global food situation, to develop concrete proposals for the acceleration of food production in developing countries and the establishment of international food reserves, and to address long term issues such as food research and technology, the energy-food nexus, and the development of markets and market mechanisms.

*The Global Round.* The Global Round is a program of study and discussion on the North-South negotiation process, carrying on the work of the Brandt report and other international development reports. The purposes of the Global Round are to identify areas of mutual interest between North and South, to consider proposals for the restructuring of the Bretton Woods institutions, and to work with other international organizations toward the worldwide elimination of absolute poverty by the end of the century.

*Roundtable on Money & Finance.* This most recent program of the North South Roundtable has established an informal process of dialogue among policy makers in the public and private sectors, to initiate appropriate policies for the resolution of the current crisis in international finance. The Roundtable on Money & Finance has organized a task force of financial and development experts to assess the crisis — especially the flaws of the present system in adjustment and liquidity creation and in the relationship between private and international financial institutions — and to consider and formulate proposals for the revitalization of the world financial and trading system.

## *North South Roundtable Publications*

*Beyond the Brandt Commission*, edited by Khadija Haq, 1980. NSRT, 120 pp.

*Energy and Development: An Agenda for Dialogue*, by Salah Al-Shaikhly and Mahbub ul Haq, 1980, NSRT, 25 pp.

*Energy for Development: An International Challenge*, by John Foster, Efrain Friedmann, James W. Howe, Francisco R. Parra and David Pollock, 1981, Praeger, 304 pp., paperback.

*Energy and Development: Policy Issues and Options*, by John Foster, Mahbub ul Haq and Francisco Parra, 1981, NSRT, 100 pp.

*A Global Agenda for the Eighties*, edited by Khadija Haq, 1981. NSRT, 128 pp.

*Castel Gandolfo Report on Renewable Energy: Policies and Options*, by Maurice Strong and Mahbub ul Haq, 1981, NSRT, 25 pp.

*Food Security for People and Nations*, by Hossein Ghassemi, Khadija Haq, Dale Hill and Martin McLaughlin, 1982, NSRT, 76 pp.

*Cancun: A Candid Evaluation*, by Roundtable Members, 1982, NSRT, 88 pp.

*Global Development: Issues and Choices*, edited by Khadija Haq, 1983, NSRT, 231 pp.

*Crisis of the '80s*, edited by Khadija Haq, 1984, NSRT, 317 pp.

## Appendix D

### *The Society for International Development*

is an independent nongovernmental organization whose purposes are to provide a forum for collective reflection and encourage a mutually educating dialogue on development, at all levels. The Society was founded in 1957 and has evolved into several interlocking networks — including its membership and chapter organizations — where individuals and institutions are linked in different ways around a varied range of activities.

SID's major programs are as follows:

1. The North South Roundtable — an intervention into the dialogue at the international level;
2. The Alternative Development Strategies Program, along with the Society's journal, *Development: Seeds of Change — Village Through the Global Order*, acting as catalysts in the national level dialogue;
3. The Grass Roots Initiatives and Strategies — an attempt to link the knowledge and technology emanating from spontaneous people-oriented activities in industrialized and Third World countries at the local level.