CHAPTER 2

The United States and Economic Development

AFTER WORLD WAR II, the United States in cooperation with other countries established the basic policies and institutions of the open system of world trade and investment that has since guided economic relations among nations. On the whole, the world has enjoyed an extraordinary record of economic progress under this system. Between 1950 and 1984, U.S. real per capita gross national product (GNP) rose at a 1.8 percent average annual rate, allowing nearly a doubling of average real living standards in 34 years. In the other nine largest Western industrial countries, real per capita income rose at a spectacular 3.7 percent average annual rate, implying that real living standards in these countries (as measured by real per capita GNP) rose by more than twice as much as they had in all of previous history. Despite disappointing economic performance of some developing countries, the average annual rate of growth of real per capita income for all developing countries was 2.8 percent between 1955 and 1984, implying more than a doubling of average real living standards in these countries in just 29 years.

The progress of developing countries over the past three decades is manifested in other important indicators of human welfare. Between 1955 and 1984, their population nearly doubled. Despite the problems of some developing countries, this increase in population was not accompanied by increasing human misery, as some feared, but rather by generally rising real living standards that were reflected in longer life expectancies, lower infant and child mortality rates, better nutrition and health care, and higher educational attainment. For example, between 1965 and 1983, average life expectancy rose by 9 years in lower income developing countries and by 8 years in middle-income developing countries.

This overall record of economic and social progress provides the context for this chapter's discussion of important economic problems that have recently afflicted a number of developing countries and of the policies that are needed to deal with these problems. The record of long-term economic success of many countries suggests that these problems can be successfully resolved. It also suggests that retention

and refinement of the policies and institutions that helped to generate this success, together with reform of practices that have contributed to recent difficulties, is the appropriate prescription for restoring prosperity and reviving growth in countries that have suffered economic slowdown or stagnation.

To develop this main theme, it is appropriate first to discuss the substantial and growing importance of developing countries in the world economy. This is followed by a description of the general economic performance and recent economic problems of developing countries, including the problems associated with the international debt crisis. The chapter next examines economic policies that experience suggests are conducive to rapid and sustainable economic growth. The chapter concludes with a discussion of contributions that the developed countries can make to the economic performance of the developing countries and of improvements of the international economic system that can benefit all nations.

Before embarking on this discussion, it is important to stress the interest of the United States in seeking more vigorous economic growth in both developed and developing countries. Beyond wishing its friends well, the United States has a strong national interest in the economic prosperity of its allies, and has an important national interest in economic prosperity of developing countries, including especially countries striving to strengthen their democratic institutions. The United States also has an economic interest in the prosperity of other countries. Economic growth appears to be a mutually reinforcing process. For example, the rapid recovery in the United States during the first six quarters of the current expansion contributed significantly to recovery and expansion in other countries and particularly to easing of some of the economic problems of developing countries. Conversely, as discussed in Chapter 1, relatively sluggish recovery of other industrial countries and recent economic problems in many developing countries are seen as factors contributing to the deterioration of the U.S. trade balance during the current recovery and perhaps also to the slowdown of that recovery since mid-1984. Thus, for economic as well as broader national purposes, the United States has an important interest in rapid and sustainable growth in other countries.

ECONOMIC PERFORMANCE AND PROBLEMS OF DEVELOPING COUNTRIES

Developing countries are the home of three-quarters of the world's population. Their aggregate national products in 1983 were more than half of that of the United States and nearly double that of Japan.

Merchandise trade (exports plus imports) of the developing countries (including high-income oil exporters) in 1983 accounted for more than a quarter of total world merchandise trade and was more than twice the size of that of the United States, the world's largest trading country. The substantial and growing economic importance of developing countries is reflected specifically in the extent of trade between these countries and the United States and, especially during the past decade, in the flow of credit from the United States and other industrial countries to the developing countries.

TRADE BETWEEN DEVELOPING COUNTRIES AND THE UNITED STATES

The importance of trade with developing countries has been growing along with the general importance of international trade for the U.S. economy in the postwar period, especially during the past 20 years. In 1965 exports to and imports from developing countries were, respectively, 1.2 and 1.0 percent of U.S. GNP. They rose to 3.0 and 4.4 percent of U.S. GNP, respectively, in 1980. By 1984 the share of exports to developing countries in GNP fell to 2.0 percent, and the share of imports from such countries fell to 3.3 percent. The relatively small shares of exports and imports in U.S. GNP are somewhat deceiving because industries that account for about 70 percent of U.S. GNP produce either services that do not enter into international merchandise trade, or produce products that are largely nontradable. For the industries that account for the remaining 30 percent of U.S. GNP, international merchandise trade is of considerable importance. On average for these industries in 1984, exports to developing countries accounted for about 7 percent of annual product, and imports from developing countries accounted for about 11 percent of annual product.

Increased imports of some categories of manufactured goods from developing countries have been a particular cause of concern for and complaint by U.S. competitors. Without attempting to judge the merits of individual complaints, it should be noted that the United States has until recently had a trade surplus in manufactured goods with developing countries and still exports large amounts of such goods to these countries. In 1980 the United States exported $60 billion of manufactured goods to and imported $32 billion of such goods from developing countries, for a net export surplus of $28 billion. Although the magnitude of this surplus may have reflected temporary factors such as the weak dollar and the large borrowing of developing countries in 1980, the existence of such a surplus is consistent with past trends. By 1984 exports of manufactures to developing countries fell to $52 billion, while imports of manufactures from these countries rose to $64 billion, yielding a net export deficit of

$12 billion. The deterioration in the net trade position in manufactured products with developing countries, however, is proportionately smaller than the deterioration of the overall U.S. net trade position between 1980 and 1984.

The explanation of the behavior of the overall U.S. trade balance or current account balance, of course, cannot be found in analyses of changes in the bilateral trade imbalances between the United States and individual countries or groups of countries. As emphasized in Chapter 1, the overall trade balance or current account balance is a macroeconomic phenomenon whose behavior is primarily to be explained by the behavior of other macroeconomic variables, in particular economic growth of the United States in comparison with other countries, levels of saving and investment in the United States and in other countries, expenditure and tax policies of the U.S. Government and the governments of other countries, anticipated real rates of return on investments in different countries, and the real foreign exchange value of the U.S. dollar.

CREDIT FLOWS TO DEVELOPING COUNTRIES

The growing importance of financial relationships between developed and developing countries is apparent in the rapid growth of the real flow of financial resources to developing countries, as reported in Table 2–1. The net flow of funds to developing countries (in 1983 dollars), as estimated by the Organization for Economic Cooperation and Development (OECD), nearly doubled in real terms between 1970 and 1980, from $53.1 billion to $93.9 billion. After peaking in 1983 at $118.3 billion, this flow declined to $92.3 billion in 1984. The sources of these funds have shifted substantially over the past 15 years. In 1970 official development assistance accounted for 42 percent of the net flow of funds to developing countries, while lending by commercial banks accounted for only 15 percent of the total. By 1983 the share of official development assistance declined to 29 percent, while the share of bank lending (including rescheduling) rose to 46 percent. This trend was reversed in 1984, when the share of official development assistance rose to 39 percent of net lending and the share of commercial banks fell to 26 percent. More recent information indicates a further substantial decline in commercial bank net lending to developing countries in 1985.

By 1983 total external liabilities of developing countries reached an estimated $843 billion, equal to about one-third of the annual GNP of these countries and about 10 percent of the annual GNP of the developed countries. More than half of these liabilities were loans from commercial banks, and nearly a third of these bank loans were owed to U.S. financial institutions. The problems recently experi-

TABLE 2-1.—*Real net flow of funds to developing countries, selected years, 1970-84*

[Billions of 1983 dollars]

Type of receipt	1970	1975	1980	1981	1982	1983	1984
Official development assistance	22.2	31.6	36.1	36.2	33.7	33.8	35.8
Grants by private voluntary agencies	2.3	2.0	2.2	2.0	2.3	2.3	2.5
Nonconcessional flows	28.7	51.0	55.7	68.6	60.1	82.1	54.0
Official or officially supported flows	10.4	15.7	22.9	21.6	21.9	19.8	20.0
Private flows	18.3	35.4	32.8	47.0	38.2	62.3	34.0
Direct investment	9.7	16.9	9.9	16.8	11.8	7.8	9.5
Bank lending[1]	7.9	17.8	21.6	29.2	25.9	54.0	24.0
Bond lending	.8	.6	1.3	1.1	.5	.5	.5
TOTAL	53.1	84.6	93.9	106.8	96.1	118.3	92.3

[1] Includes for 1983 and 1984 significant amounts of rescheduled short-term debt.

Note.—Detail may not add to totals due to rounding.

Source: Organization for Economic Cooperation and Development.

enced by several of the high-debt countries in meeting their debt-service obligations, and the consequences of these problems for the financial institutions that hold their obligations, have dramatized the deepening financial relationships between developing countries and the United States and other developed countries.

ECONOMIC PROBLEMS OF DEVELOPING COUNTRIES

Economic growth in developing countries has been rapid over the past 30 years, on average, as indicated in Table 2-2. Some countries, however, have not shared in this progress over the long run, and, in the past few years, a number of countries with relatively good long-run performance have experienced economic difficulties. The chronic economic problems of many quite poor countries in Sub-Saharan Africa, South Asia, and Latin America deserve treatment separate from the acute difficulties recently experienced by middle-income countries with large debt burdens.

The low-income developing countries (those with per capita incomes of less than $400 in 1983) had an average annual growth rate of real per capita GNP of 2.3 percent between 1955 and 1984. This result is dominated by the performance of China and India, which together account for three-quarters of the population of low-income developing countries and which had a combined average annual growth rate of real per capita GNP of 2.4 percent over this period. Interestingly, the combined growth performance of these two large countries has been improving recently as they have adopted more market-oriented, pro-growth economic policies. Some other low-income developing countries have also enjoyed vigorous growth, in-

cluding some spectacularly successful countries that earlier adopted market-oriented, pro-growth economic policies and have now graduated to the class of middle-income developing countries. In many other low-income countries growth performance has not been very strong. Between 1965 and 1984, real per capita income in the low-income countries of Sub-Saharan Africa rose at only a 0.5 percent average annual rate.

TABLE 2-2.—*Indicators of economic growth, 1955-84*

[Annual growth rate; percent]

Period	Population	Real GNP	Real GNP per capita
DEVELOPING COUNTRIES:[1]			
1955-70	2.2	5.4	3.1
1970-80	2.2	5.3	3.1
1980-84	2.0	3.1	1.1
Low-income countries:			
1955-70	2.1	3.7	1.6
1970-80	2.1	4.5	2.4
1980-84	1.8	6.7	4.9
Middle-income countries:			
1955-70	2.4	6.0	3.5
1970-80	2.4	5.6	3.1
1980-84	2.4	1.8	-.6
INDUSTRIAL MARKET COUNTRIES:			
1955-70	1.1	4.7	3.6
1970-80	.8	3.2	2.4
1980-84	.5	1.8	1.3

[1] Excludes the high-income oil exporters.

Source: International Bank for Reconstruction and Development.

The road to economic prosperity for many of the poorest countries will be a long and difficult one. In some extreme situations, such as the recent and continuing famine in Ethiopia, extraordinary external assistance has been essential to provide the bare requirements of human survival. The success of some formerly quite poor countries, however, gives hope that some of today's poorer countries will be able to graduate to the ranks of the middle-income developing countries by early in the next century.

The middle-income developing countries (those with per capita incomes between $400 and $7,000 in 1983) had good growth performance on average between 1955 and 1984. As a group, they recorded an average annual growth rate of real per capita income of 2.8 percent per year, enabling the real income of the average resident of these countries to rise by 123 percent in just 29 years. Some countries, of course, performed less well than the average, and a few even registered substantial declines in real per capita incomes over periods of two decades or longer. On the other hand, nine countries had growth rates of real per capita income of 5 percent per year or better

between 1965 and 1983, implying an increase in real per capita income of more than 140 percent in just 18 years.

The early 1980s have been a period of sharp contrasts in the economic performances of developing countries. For all developing countries, excluding the high-income oil exporters, the average growth rate of real per capita income was only 1.1 percent per year between 1980 and 1984. Thanks primarily to the good performance and large weight of China and India, low-income developing countries registered a 4.9 percent average annual growth rate of real per capita income over these 4 years. Other low-income countries in Asia did about as well as China and India, on average, but low-income countries in Africa suffered a cumulative 8.7 percent decline in average real per capita income over these 4 years. For the middle-income developing countries, average real per capita incomes declined at a 0.6 percent annual rate between 1980 and 1984. Despite the recession in the industrial countries, some of these countries, especially in Asia, continued to enjoy strong real growth. Other middle-income developing countries, especially in Latin America, had enjoyed generally good growth during the 1960s and 1970s, but experienced economic stagnation or decline in the early 1980s.

EFFECTS OF EXTERNAL SHOCKS

For developing countries that experienced poor economic performance in the early 1980s, adverse external economic developments explain part, but only part, of this poor performance. Some countries whose national incomes depend heavily on revenues from oil exports saw their real national incomes decline because of the fall in world oil prices and in the volume of oil exports. However, some oil-exporting countries that saved some of their oil-export revenues in the 1970s have been able to draw on those savings to support domestic consumption and investment during a period of lower oil prices and export volumes. Other oil exporters that spent all of their export revenues and even borrowed from world capital markets to spend on consumption and domestic investment have faced a more difficult task in adjusting to lower oil exports and oil prices. The same is true for developing countries that experienced export booms for other commodities during the 1970s and failed to foresee that these booms might not last forever.

Moreover, evidence suggests that adverse external events are not primarily responsible for the recent poor economic performance of some developing countries. As previously mentioned, other developing countries that faced similar external circumstances continued to perform well in the early 1980s. Table 2-3 summarizes results from a World Bank study that compared the magnitude of external shocks to

developing countries that needed to reschedule their external debts by the end of 1984 with countries that did not need to reschedule. The index of external shocks was calculated as the combined effects on a country's balance of payments of deteriorations in its terms of trade (the ratio of export prices to import prices), declines in world demand for its exports, and increases in interest rates on its outstanding external debt. In 1979–80 and 1981–82, the average adverse external shock was about the same for reschedulers and nonreschedulers. The average of annual growth rates of real gross domestic product (GDP) in 1979–83 for reschedulers, however, was only 0.9 percent, versus 4.3 percent for nonreschedulers.

TABLE 2-3.—*External shocks and real GDP growth in selected developing countries, 1979–83*

Country Category	Net external shocks as percent of GNP[1]		Growth of real GDP (percent)[2]
	1979–80	1981–82	1979–83
Reschedulers[3]	−2.6	−9.3	0.9
Nonreschedulers	−2.6	−8.4	4.3

[1] External shocks are defined as the impact on the balance of payments as a percentage of GNP of: (a) changes in the terms of trade; (b) a decline in the growth rate of world demand for a country's exports; and (c) increases in interest rates, averaged across countries.
[2] Averaged across countries and years.
[3] Countries that had rescheduled debt as of the end of 1984.

Sources: International Bank for Reconstruction and Development, *World Development Report, 1985*, and International Monetary Fund, *International Financial Statistics Yearbook, 1985*.

External shocks did, of course, affect developing countries in the early 1980s. The disinflation of the early 1980s was associated with an unwinding of the effects of the inflation of the 1970s on relative commodity prices, including prices of some products exported by developing countries. The recession in the industrial countries in the early 1980s reduced demand for the exports of developing countries. The real burden of the external, dollar-denominated debt of many developing countries rose as the dollar appreciated in foreign exchange markets. Increased nominal and real interest rates, especially in 1981, increased the debt-service requirements of heavily indebted countries with large amounts of floating-rate loans. Countering these adverse developments have been the recovery in the industrial countries, especially the United States, and the decline in interest rates since 1982, plus the recent moderate decline of the dollar.

The effects of movements in interest rates and in the foreign exchange value of the dollar on debt-service burdens were important for developing countries that chose, as a consequence of the policies they pursued, to borrow large sums from international capital markets. The problems of these countries are best understood in the context of a general discussion of the role of international credit flows and the current international debt situation.

The international flow of capital performs at least two important economic functions. It allows countries with more attractive investment opportunities than can be financed out of domestic saving to obtain resources from countries with excess savings. It also allows countries suffering temporary economic difficulties to borrow from world capital markets rather than institute sharp temporary reductions in consumption or costly cutbacks in investment.

International capital flows have performed these functions for many countries over a long span of time. In the 50 years prior to World War I, the United States, Canada, Australia, Argentina, and the Scandinavian countries financed domestic investments with substantial loans from Great Britain and other European countries. The evidence indicates that despite occasional defaults and other difficulties, the providers of this credit earned higher returns than those typically available on investments in their own countries. In most of the period since World War II, the United States has been a net supplier of capital to the rest of the world, especially through the mechanism of direct investment by U.S. firms in foreign countries. The generally higher real growth rates of other industrial countries up to 1975 and of developing countries up to 1980 suggest that this flow of capital out of the United States was generally in the direction of higher returns. During the current expansion, the United States has become a net borrower in world credit markets. This is consistent with the high rate of return on and rapid growth of investment in the United States, in comparison with other countries, and with the need to finance the Federal deficit. The suppliers of credit to the United States are primarily other industrial countries where desired saving rates exceed desired rates of domestic investment.

With the exception of some oil-exporting countries, developing countries have generally been recipients of net capital inflows in the postwar period. Evidence indicates that from the mid-1960s to the late 1970s, there was a generally positive relationship between the growth of external indebtedness of particular developing countries and the growth of investment in these countries. Evidence suggests a similarly positive relationship between the growth of external indebtedness and the growth rate of real gross domestic product. This is consistent with the notion that international capital flows were, on the whole, performing the desirable function of financing investment in countries with good growth opportunities. From 1979 to 1983, however, there is no significant relationship between growth of external indebtedness and growth of investment for developing countries, and there is a negative relationship between growth of external debt and growth of real domestic product.

In the 1960s and 1970s, a few developing countries experienced difficulties in meeting their debt-service obligations and had to reschedule their external debts. At least up to 1979, however, these problems affected no more than two or three countries in any year, and the total amount of debt rescheduled in any year did not exceed $2 billion. In 1979, 7 countries rescheduled $6.2 billion of external debts; in 1980, 6 countries rescheduled $3.7 billion; and in 1981, 13 countries rescheduled $5.8 billion. In 1982 reschedulings fell when 9 countries rescheduled $2.4 billion; but in 1983, 21 countries rescheduled $51 billion; and in 1984, 24 countries (many of them the same as in the preceding year) rescheduled $116 billion. Because rescheduling agreements are typically reached some time after a country begins to experience debt-servicing difficulties, it is reasonable to conclude that by 1982 many of the developing countries with large external debts were already in trouble.

THE INTERNATIONAL DEBT SITUATION

A stylized description of events leading up to the recent international debt crisis is the following. Starting in 1973, growth of balance of payments surpluses of some high-income oil-exporting countries stimulated expansion of the international banking system that recycled these surpluses. Increased availability of credit on attractive terms through the international banking system increased opportunities for many developing countries to become borrowers from that system in the mid-1970s. Initially, debt-service requirements did not rise relative to the export earnings of many of these countries because they enjoyed rapid economic growth and because the inflationary expansion of the 1970s contributed to a boom in demand for their exports. Moreover, nominal interest rates on dollar-denominated loans declined from 1974 to 1976 and rose modestly between 1976 and 1978. Real interest rates became increasingly negative during the late 1970s as inflation accelerated. In addition, depreciation of the dollar relative to the currencies of other industrial countries after 1976 reduced the value of the dollar-denominated debt of many countries, thereby making further borrowing seem even more attractive.

In 1981–83 difficulties arose for many developing countries that had borrowed extensively from the international banking system in the late 1970s and 1980. The recession in the industrial countries, the high level of nominal and real interest rates (especially from late 1980 through mid-1982), the strengthening of the U.S. dollar, and the declines in the dollar prices of many commodities exported by heavily indebted developing countries (associated with the undoing of the inflationary excesses of the 1970s) contributed to an increase

in the debt-service requirements of these countries relative to their export earnings, especially for countries with large volumes of dollar-denominated, floating-rate loans. To meet rising debt-service requirements, many debtor nations increased external borrowing. These high levels of borrowing, together with deteriorating export earnings and slackening economic growth, caused concern among lenders about the longer run capacity of these countries to meet their external debt-service obligations.

Table 2–4 presents data for two groups of debtor countries that are useful in understanding the debt crisis. Group A consists of indebted developing countries that incurred external payments arrears between 1981 and 1983 or rescheduled their external debts between 1981 and mid-1984. The 57 countries in group A accounted for 42.8 percent of GDP and 59.5 percent of the external debt of all developing countries in 1980. Group B consists of those indebted developing countries that did not experience recent debt-servicing difficulties. The 66 countries in group B accounted for 43.2 percent of GDP and 40.5 percent of the external debt of all developing countries in 1980. These two groups had the same average annual growth rate of real GDP, 5.5 percent per year, from 1967 to 1976. Both groups enjoyed substantial growth between 1976 and 1980, although even by this stage, countries in group B (with generally lower external debt burdens) were growing somewhat more rapidly. The growth rate of real GDP for group A fell to 1.1 percent in 1981, to −0.1 percent in 1982, and to −1.9 percent in 1983, and was estimated to be only 2.0 percent in 1984. In contrast, group B continued to enjoy impressive growth rates of real GDP, with annual growth rates of 5.1 percent in 1981, 4.0 percent in 1982, 5.4 percent in 1983, and an estimated 5.7 percent in 1984.

Another important difference between these two groups is the behavior of their respective current account balances. On average, from 1967 to 1976, group A had a slightly larger current account deficit as a percentage of exports of goods and services than group B. By 1977 the current account deficit as a percentage of exports had risen to 25.5 percent for group A, while it was only 6.1 percent of exports for group B. In the late 1970s and early 1980s the current account deficit of group B remained modest, peaking at 14 percent of exports in 1981. For group A the current account deficit remained much larger, peaking in absolute size in 1981, and relative to exports at 33.3 percent in 1982. An important factor contributing to the larger current account deficit of group A was the interest they had to pay on their larger external debt.

A current account deficit implies an excess of national spending over national income that must somehow be financed. The primary

TABLE 2-4.—*Debt indicators for developing countries, 1967-84*

Indicator by country group[1]	1967-76 average	1977	1978	1979	1980	1981	1982	1983	1984[2]
	Percent								
Growth of real GDP									
Group A	5.5	5.4	3.7	5.3	3.9	1.1	−0.1	−1.9	2.0
Group B	5.5	6.3	8.2	4.7	4.9	5.1	4.0	5.4	5.7
	Billions of U.S. dollars								
Exports of goods and services									
Group A	.....	107.8	117.3	154.5	201.3	207.4	185.4	178.2	192.1
Group B	.....	154.5	183.5	240.1	310.5	328.2	319.1	322.5	354.9
	Percent of exports of goods and services								
Current account balance									
Group A	−18.5	−25.5	−31.9	−25.3	−23.7	−32.2	−33.3	−14.4	−7.6
Group B	−13.3	−6.1	−10.6	−9.4	−9.4	−14.0	−12.9	−10.5	−6.5
Net external borrowing									
Group A	.....	29.5	36.1	28.8	32.3	37.5	32.2	18.3	11.0
Group B	.....	8.9	10.9	10.5	10.6	12.9	11.9	10.2	7.2
Net asset transactions plus errors and omissions									
Group A	.....	−7.4	−5.9	−3.4	−10.0	−14.5	−16.7	−6.2	.....
Group B	.....	−3.1	−1.6	−2.5	−2.2	−2.1	−2.2	−2.7	−2.2
External debt									
Group A	.....	171.7	195.8	178.1	167.1	194.5	246.0	268.1	256.8
Group B	.....	95.3	91.9	81.6	73.6	78.3	91.1	97.0	94.2
Debt-service payments									
Group A	.....	22.3	29.6	30.2	26.9	33.8	41.6	36.2	36.6
Group B	.....	10.0	11.8	11.7	11.0	12.7	14.6	14.4	14.9

[1] Group A: countries with recent debt-servicing problems.
Group B: countries without debt-servicing problems.
[2] Estimates.
Source: International Monetary Fund, *World Economic Outlook, 1985.*

means of finance for developing countries is usually external net borrowing. This is shown in Table 2-4 in the close relationship between net external borrowing as a percentage of exports and the current account balance as a percentage of exports for both groups of countries. Not surprisingly, debt-servicing difficulties are associated with countries that run large and persistent current account deficits that need to be financed by large and persistent net external borrowing.

Loss of confidence in a country's creditworthiness might be expected to affect internal as well as external creditors, leading to a flight of domestic capital. This is reflected in Table 2-4 in the behavior of net asset transactions plus errors and omissions in the balance of payments. As a percentage of exports, these items remain quite small for group B, which did not experience debt-servicing problems. For group A, however, these items grow quite large in 1980-82.

Adverse external developments can contribute to a loss of confidence in creditworthiness. A decline in export earnings due to a decline in world market demand for a country's exports may cause creditors to worry about the security for their loans. For a country

with a large amount of floating-rate debt, an increase in interest rates increases debt-service requirements. This tends to worsen the current account balance, thereby contributing to creditor worries. Such events did adversely affect many heavily indebted developing countries in the early 1980s. However, the extent of these effects depended on the size of a country's external debt. In Table 2-4, group A has a higher ratio of debt service to exports in both 1977 and 1982 and a larger increase in this ratio between 1977 and 1982 than group B. This is not because group A faced higher interest rates or a larger increase in interest rates. It is because they had a higher ratio of external debt to exports in 1977 and a larger increase in this debt ratio between 1977 and 1982. Especially in developing countries where most external debt is government debt, the effects of changing interest rates on debt-service problems are a mixture of the effects of external events and of past government policies.

When a country experiences debt-servicing difficulties, its creditors tend to want to reduce their exposure by collecting all interest and principal payments as they come due, while extending no new credit. This may be neither desirable nor feasible. For the countries that experienced debt-servicing difficulties to pay all of the interest and principal on their external debts in 1982, without any new gross external borrowing, they would have had to move from net external borrowing equal to 37.5 percent of exports in 1981 to net external lending equal to principal payments on outstanding external loans (probably about 20 percent of exports). This would have required these countries to improve their trade balances in 1982 by more than $100 billion, relative to actual performance. Engineering such a massive change in the trade position of these countries was probably not feasible in so short a time, and it certainly would have been very costly. Moreover, it is questionable whether the major creditor countries, including the United States, would have wished to see a deterioration of more than $100 billion in their own trade balances, which would have been the necessary counterpart of an improvement of similar magnitude in the trade balances of debtor countries. To deal with this problem, debtor countries and their creditors normally attempt to negotiate rescheduling arrangements under which the creditors agree to extend the time period for repayment of the principal and sometimes part of the interest on existing loans.

THE ROLE OF THE INTERNATIONAL MONETARY FUND

In most cases, debt rescheduling involves formal standby lending arrangements with the International Monetary Fund (IMF). The IMF establishes such arrangements as part of its general function to pro-

vide financial support to countries experiencing balance of payments difficulties, provided that they adopt policies holding promise of correcting these difficulties. Typically, under these agreements, the IMF provides only part of the new credit extended to a debtor country, but the agreement is frequently an effective precondition for a rescheduling arrangement with other creditors. As a condition for IMF support, countries agree to pursue policies directed at improving their capacity to meet their external obligations. Usually, the agreed policies seek reductions or limitations of government spending, government borrowing, and credit and money creation. The policies are intended to reduce domestic spending relative to domestic income and thereby improve the current account balance. In many cases, a devaluation of the exchange rate is also adopted as a means of improving the current account balance by increasing the price of internationally traded goods relative to home goods. Such a relative price change tends to reduce imports, increase exports, and shift resources toward the tradable goods sector of the economy.

The IMF has been criticized, in some quarters, especially in developing countries, on the grounds that it recommends policies that focus too strongly on achieving short-term improvements in the balance of payments, rather than promoting longer term growth, and that contribute downward pressure on economic activity in countries already subject to strong recessionary forces. It is certainly true that several countries that adopted economic policies recommended by the IMF suffered severe recessions in the early 1980s. It is far less clear that these policies were primarily responsible for the severity of these recessions or that, under the circumstances, there was any real alternative to adopting some of these policies. These circumstances included the cumulative effects of past government policies and of adverse external events that contributed to the loss of confidence in the creditworthiness of a number of heavily indebted developing countries. A country that cannot borrow because of lost confidence in its creditworthiness must adopt policies that keep the excess of spending over income within the range of permitted borrowing. Because its own resources are limited, the IMF's capacity to expand the supply of credit (including borrowing to make debt-service payments) depends partly on its capacity to persuade other creditors that policies undertaken by debtor countries offer reasonable hope of restoring creditworthiness. Moreover, some of the countries that have established standby agreements with the IMF have improved their current account balances. This task might well have proved more difficult and more painful without the assistance of the IMF.

The critical issue for the future is how to resolve the economic problems of debtor countries in the manner most advantageous to

them, to their creditors, and to the world as a whole. The mutually advantageous resolution is clearly one that restores these countries to paths of rapid, sustainable, noninflationary economic growth, thereby assuring creditors of repayment and benefiting the world economy through a general expansion of trade and economic activity. This most desirable outcome requires that developing countries pursue policies that support their own economic growth and structural adjustment, that the United States and other industrial countries maintain high and stable rates of economic growth, and that the nations of the world cooperate in sustaining an open system of international trade and investment that enables each of them to realize its full economic potential.

POLICIES FOR ECONOMIC GROWTH AND DEVELOPMENT

Achievement of a rapid rate of economic growth has been a key objective of economic policy in many older and newly emergent developing countries for the past three decades. Different countries at different times have pursued a wide array of different policies in their efforts to stimulate and sustain rapid rates of growth, and have enjoyed varying degrees of success in these efforts. From this wealth of experience, it is possible to learn a good deal about economic policies likely to support successful development and about policies likely to inhibit economic growth.

ESTABLISHING APPROPRIATE INCENTIVES THROUGH RELATIVE PRICES

One basic lesson is that the rules governing economic behavior in developing countries do not fundamentally differ from the rules governing such behavior in more economically advanced countries. Allowed the opportunity to pursue their own interests, individuals respond to the incentives implicit in the relative prices of products they consume and produce and of factor services they sell or employ. Hence, it is crucial that economic policies operate to confront individuals with relative prices of products and factors that accurately reflect their true values and allow them to respond appropriately to the incentives embodied in these prices.

The importance of this point has not always been recognized in either developing or developed countries. For example, policies that depress prices of agricultural commodities in many developing countries are often seen as benefiting low-income consumers, without much reducing agricultural production. Experience demonstrates the error of this supposition. When prices of cash crops are depressed by export taxes, overvalued exchange rates, or price controls, production declines as farmers shift to crops with higher market prices or

shift back to subsistence agriculture, sometimes with disastrous consequences for the national food supply. The opposite side of this coin has been observed in many developed countries where programs to support prices of agricultural products have generated mountains of surplus grain, oceans of surplus dairy products, and enough sugar production to please even Mary Poppins.

Another recent example of this fallacy is the supposed lack of responsiveness of producers and consumers to changes in the price of energy. After 1973 the U.S. Government imposed controls on the prices paid to domestic producers of oil and natural gas and on standards for energy consumption, including fuel economy standards for automobiles. Part of the rationale for these controls was the supposition that allowing domestic energy prices to rise would redistribute income from energy consumers to domestic energy producers, but would have little effect on the quantities of energy produced and consumed. However, as discussed in Chapter 5, energy production in the United States responded strongly to the incentives provided by higher prices. Similarly, when consumers faced higher energy prices, they demanded higher gas mileage vehicles, better insulated homes and factories, and more energy-efficient equipment and applicances.

The relevance of this point is not limited to the United States. In some oil-exporting countries, domestic fuel prices were kept well below world market levels throughout the 1970s. When the economic situation of many of these countries deteriorated in the early 1980s, there was resistance to raising domestic fuel prices as a means of conserving a valuable resource because it was believed that price increases would reduce real incomes of fuel consumers without stimulating much conservation. Countries that raised domestic fuel prices, however, found that fuel consumption responded to the incentives created by higher prices.

MAINTAINING REASONABLE FISCAL DISCIPLINE

A second basic lesson from experiences with economic growth is the virtue of maintaining reasonable fiscal discipline. This requires that governments not run large and persistent fiscal deficits, especially deficits financed by inflationary money creation or by heavy foreign borrowing, and that the size of the public sector be limited.

The "reasonable" size of the fiscal deficit depends on the situation and circumstances of particular countries. A country that enjoys rapid economic growth can usually expand its money supply more rapidly without generating inflation than a country that suffers slower economic growth. A country with good credit standing can finance a temporary fiscal deficit by foreign borrowing, while a country with a

poorer credit rating may not have this option. A country that devotes a large fraction of its income to productive and profitable investments can sustain a higher rate of foreign borrowing than a country that does not invest as much in its future growth. However, the experience of many developing countries in the international debt crisis of the early 1980s demonstrates the dangers and disadvantages of policies that lead to persistent, large-scale foreign borrowing.

More generally, experience indicates that countries whose governments run large and persistent fiscal deficits (sometimes exceeding 8 or 10 percent of national income) may enjoy rapid economic growth for a while, but sooner or later they suffer severe economic difficulties. These difficulties may become acute during periods when deficits are being curtailed, thereby complicating observed relationships between fiscal deficits and economic performance. The painful effects of reducing government deficits, however, should be attributed to their basic cause. We suffer hangovers not because we stop drinking, but because we drank too much in the first place.

The appropriate size of the public sector is a critical issue to be resolved by any society. Experience does not provide unambiguous evidence that the size of the public sector, within a certain range, is strongly and negatively correlated with the rate of economic growth, but it does suggest that large public sectors are not associated with superior growth performance. For the industrial countries, the share of government spending in GNP has generally risen over the postwar period, and the rate of economic growth has generally declined. Japan has enjoyed the highest rate of economic growth among the major industrial countries and has also had the lowest share of government spending in GNP. In the 1950s and 1960s, Western European countries generally had higher rates of economic growth than the United States, even though they generally had somewhat larger public sectors. More recently, however, as many Western European countries have increased their share of public spending, their growth performance has fallen off, both absolutely and relative to the United States. Among developing countries, the evidence is mixed concerning the cross-sectional relationship between the size of the public sector and the rate of economic growth. There are, however, a number of examples where rapid growth of the public sector has been associated with a deterioration of growth performance. Moreover, large public sectors generally need to be supported (sooner or later) by high taxes. High tax rates create disincentives for working, saving, and investing, and, as some evidence shows, tend to be associated with lower rates of economic growth.

For a country with a large public sector, it is especially important that the public sector be run efficiently. Public sector enterprises that

provide services similar to those that might be provided by private firms (such as electricity or transportation) should meet the standards of efficiency and profitability normally expected of private sector enterprises. Some public sector enterprises may meet this performance criterion; many do not. Often, employment in public sector enterprises is artificially high and wage and benefit levels for workers and managers of such enterprises exceed levels generally prevailing in the private sector. As discussed in Chapter 5, public sector enterprises in the United States are less efficient than their private sector counterparts. Evidence suggests that public sector enterprises in developing countries also suffer from serious inefficiencies, implying that substantial gains can be made by making public sector enterprises behave more like private firms or, better still, by shifting their activities to private firms.

Restoring fiscal discipline is a politically painful exercise. The short-run effect of either a reduction in government spending or an increase in taxes may be a decline in economic activity. The longer run effect of higher taxes, which distort economic incentives, is likely to be a lower level of real income. Moreover, the beneficiaries of deficit spending see themselves harmed by spending cuts, by tax-rate increases, or by efforts to expand the tax base. There is an important asymmetry here. Recipients of subsidized public services, transfer payments, or special tax breaks frequently blame governments for reducing these benefits. They do not protest with similar intensity the failure to provide such benefits in the first place. Hence, to maintain reasonable fiscal discipline, it is important not to initiate programs that may become expensive and are likely to generate interest groups supporting their continuation.

RESTRAINING GENERAL PRICE INFLATION

A third basic lesson is that a rapid rate of price inflation is generally associated with relatively poor growth performance. For the industrial countries, the higher inflation period of the 1970s and early 1980s generally brought poorer economic performance than the lower inflation period of the 1950s and 1960s. Some developing countries with inflation rates in the range of 20 to 40 percent per year have enjoyed reasonably good real growth. When inflation rates have accelerated to 50 percent per year or higher, however, growth performance has generally been poor relative to lower inflation periods. Inflation rates of 100 percent per year or higher have frequently been associated with economic stagnation or decline. Successful efforts to reduce high inflation rates have usually been associated with higher real economic growth. Countries enjoying the highest real growth rates have generally had low or moderate inflation rates.

The causal linkage between high inflation and poor growth is complex. Because governments often resort to inflationary policies when their economies are not performing well, inflation can be a symptom as well as a cause of poor economic performance. In theory, a country could have a high and predictable rate of inflation, and could adjust its economic institutions (including its tax system) to such inflation. In practice, high inflation rates are usually variable and unpredictable. High and variable inflation rates tend to induce wide variations in relative prices that interfere with the signals concerning the appropriate allocation of resources. With high and variable inflation rates, economic agents divert time, effort, and resources from productive activities into socially unproductive efforts to profit or to avoid losses from inflation and its attendant effects. Inflation frequently interacts with other distortions of the economic system to impair economic performance. For example, taxation of interest and other returns from capital on a nominal rate of return basis produces high real effective rates of taxation in the presence of high inflation. Schemes for indexing wage rates and other economic variables to deal with the problems of inflation can reduce the flexibility of the economy to deal with other types of disturbances. Under general price inflation, controlled nominal prices of basic commodities and public services frequently result in low relative prices of these goods and services. Governments are often reluctant to raise these controlled prices for fear that it will contribute to inflation or stimulate political protests. Enlarged fiscal deficits necessary to finance high real subsidies on basic commodities and to pay for the deficits of public sector enterprises, however, can stimulate increased money creation that in turn accelerates inflation.

MAINTAINING AN OPEN POLICY TOWARD INTERNATIONAL TRADE

A fourth basic lesson is that an outward looking, open policy toward international trade tends to be conducive to rapid economic growth. The essence of such a policy is that internal relative prices of internationally traded goods are not forced to diverge too far from world market prices because of import tariffs or quotas, exports taxes or subsidies, multiple or misvalued exchange rates, or other government policies. An open policy toward international trade allows for relatively unrestricted importation of products cheaply available in world markets and for exportation of products in which a country has or can develop a comparative advantage.

This contrasts with the inward looking, import-substitution policies adopted by many developing countries early in the postwar period. The objective of these import-substitution policies was to stimulate economic growth by encouraging development of domestic industries

to produce products (especially manufactured products) previously imported. The tools were high-import tariffs, restrictive import quotas, foreign exchange licensing schemes, and other protective devices. In a few extreme cases, domestic producers could even obtain absolute prohibitions of imports on the promise that they would supply domestic substitutes.

Many studies have shown that relatively open policies toward international trade provide a better environment for economic growth in developing countries than policies of import-substitution. The most rapidly growing countries generally have relatively open trade policies. Countries that have shifted from import substitution to more open policies have generally improved economic performance. In contrast, import-substitution policies have produced large distortions between the domestic relative prices of tradable goods and the true costs of these goods, as reflected in world market relative prices. As a result, resources were diverted from potential export activities into production of high-cost domestic substitutes for products that could be purchased more cheaply in world markets. In addition, smaller countries that adopted import-substitution policies lost economies of scale by attempting to produce a diversified range of products for a small domestic market, rather than concentrating on a more limited range of products to be produced for export as well as domestic consumption. In some cases, loss of productive efficiency was exacerbated by a decline in market discipline on domestic firms and their workers because these firms faced little internal competition and were shielded from foreign competition.

Some countries with relatively open policies toward international trade have provided temporary protection for some import-competing industries or have given direct or indirect export subsidies to some industries (including preferential tax treatment and favorable tariff rates on imported inputs used in these industries). In some cases, special privileges accorded to particular industries may merely offset other distortions that impair the exploitation of natural comparative advantage. Although there are a few examples of successful industrial targeting, there are also many examples of industries that have become successful exporters without benefit of specific targeting by government authorities. There are also examples of industries targeted for development that never proved especially successful. Worst of all are the examples of targeted industries that continue to require subsidies or protection long after they were initially selected for special assistance. The general lesson appears to be that industrial targeting may occasionally succeed when a government has the luck to select the right industries for development. But there is a danger that special government privileges will be supplied

for long periods to industries with little development potential. Moreover, if private sector investors err in selecting an industry for development, they bear an important part of the cost of that mistake, rather than passing it on to the rest of society. For this reason, there is less danger that the private sector will prolong activities that prove unsuccessful.

Given that most countries will not pursue policies of complete free trade, it is important to recognize that some impediments to trade are worse than others. A uniform ad valorem import tariff applied to all imports is generally less distortionary than a tariff structure with the same average tariff rate but with wide variations in the tariffs applied to individual commodities. This is especially so when imported goods are used as inputs in producing other goods. In this situation, relatively small variations in nominal tariff rates can generate large differences in effective rates of protection for value added in different domestic production activities. Large differences in effective protection rates, in turn, imply large distortions of the incentives to devote domestic resources to different production activities.

In general, import tariffs are less harmful than import quotas that provide the same initial level of protection. Tariffs raise revenue for the government. The implicit revenue associated with an import quota is usually distributed to the private parties who receive quota allocations and who hence have an interest in preserving and enhancing the scarcity value of the right they have received. A tariff generally allows less latitude for the exercise of market power by domestic producers of import substitutes (or by suppliers of factors to such producers) than does an import quota. With an import tariff, the degree of protection for domestic producers relative to foreign competitors is fixed; domestic producers are therefore under pressure to match the efficiency gains of their foreign competitors. With an import quota, the discipline on domestic producers to remain efficient is often diminished because the level of protection rises to offset any deterioration in the efficiency of domestic producers relative to their foreign competitors. Systems of foreign exchange licenses, with different exchange rates for different classes of imports and exports and with complicated mechanisms for the allocation of licenses, share the disadvantages of import and export quotas and frequently offer even greater latitude for harmful manipulation.

MAINTAINING AN APPROPRIATELY VALUED EXCHANGE RATE

A fifth basic lesson from the growth experiences of developing countries is the importance of maintaining an appropriately valued exchange rate. The exchange rate is the price of domestic money in terms of foreign monies. The economically appropriate exchange

rate establishes the correct relationship between internal nominal prices of goods and services in terms of domestic money and the nominal prices of goods and services in terms of foreign monies. For most developing countries that maintain some form of pegged exchange rate, the economically appropriate exchange rate is difficult to identify with great precision. However, there is little doubt that some developing countries have injured their export industries and their overall growth performances by maintaining substantially overvalued exchange rates. Frequently, this has happened because rapid domestic inflation has transformed an initially appropriate nominal exchange rate into a substantially overvalued exchange rate.

The initial effect of an overvalued exchange rate is often to enlarge a country's trade deficit beyond the level that can be financed by the normal equilibrium level of capital inflow. In the short run, to sustain the foreign exchange value of its currency, the government may intervene in the foreign exchange market by using its official reserves or reserves borrowed on the world capital market. Alternatively, a large-scale capital inflow resulting from either official foreign borrowing or from private capital inflows can contribute to overvaluation of the exchange rate by financing an excess of domestic spending over domestic income. To sustain an overvalued exchange rate and stem reserve losses, governments frequently resort to trade restrictions and foreign exchange controls. Although the reason for imposing these restrictions may not be a desire to engage in import substitution, the effect is the same—a distortion of the economically appropriate relationship between internal and external prices and a corresponding distortion of incentives for the efficient allocation of resources.

LIMITING DISTORTIONS OF DOMESTIC PRODUCT AND FACTOR MARKETS

A sixth basic lesson from the experiences of developed and developing countries is the importance of limiting distortions of domestic product and factor markets. Such distortions can arise from the activities of private economic agents, in particular through the exercise of market power. The appropriate role of government policy in this regard is not to facilitate the exercise of market power by supporting cartels or other anticompetitive practices but to promote competition. Even more important, the government should not allow its own policies to distort excessively the markets for domestic products and factors.

Some distortion of domestic product and factor markets is the inevitable consequence of taxes used to raise revenue to finance essential government operations. The harmful distortionary effects of taxation generally rise more than proportionately with the rate of tax-

ation. They become especially acute when rates of taxation are highly variable across similar products or across different uses of the same factor of production. Hence, it is important to keep overall tax rates as low as possible and to keep tax rates relatively even across similar products and different uses of the same factor of production. Increasingly, experience suggests that low and even tax rates contribute to economic growth, presumably by maintaining incentives to work, save, and invest.

To keep overall tax rates low, it is vital to limit public spending financed by tax revenues. The appropriate rule with respect to public spending is that the marginal social value of such spending should exceed its direct cost by enough to compensate for the distortionary and collection costs of the taxes necessary to finance it. For the United States, the true social cost of Federal Government spending has been estimated at one and one-half times the direct budget cost. For many developing countries that may have higher tax collection costs and more distortionary tax systems than the United States, the marginal social cost of additional government spending is even higher relative to direct budget cost.

Further, public sector enterprises that supply goods and services in competition with private sector enterprises or that might plausibly function as private sector enterprises (such as electric utilities and suppliers of transport services) should charge prices that reflect the true costs of the goods and services they supply (adjusted for externalities associated with consumption or production of these goods and services). Such user charges do not have the distortionary effects of taxation because they make the users recognize the cost of the particular good or service they are using. Normally, public sector enterprises should generate profits that reflect a fair rate of return on the capital that the public has invested in these enterprises. The profits should be returned to the public treasury, not squandered on employment of unnecessary personnel, on excessively high wage rates for workers, or on benefits and perquisites for their managers.

Special tax exemptions, rebates, and privileges frequently cause economic distortions. They increase, sometimes to a great extent, the disparity between tax rates on activities benefiting from them and on similar activities. There also is the need to replace by raising other taxes the revenue lost because of exemptions, rebates, and privileges. Moreover, once granted, special benefits often prove to be politically difficult to remove and may stimulate others to seek similar benefits.

In addition to taxes, many other government policies can harm economic performance by distorting economic incentives. Such policies include regulations of prices, wages, and interest rates. Policies

that have maintained low prices of agricultural commodities in a number of developing countries have often discouraged agricultural production, thereby exacerbating problems of hunger and starvation while reducing the real income of rural families who are usually the poorest families in developing countries. Rent controls in both developing and developed countries generate housing shortages. Regulations that hold real wage rates above economic equilibrium levels contribute to unemployment among affected groups of workers. Restrictions on plant closings and work force reductions, such as have been used recently in some Western European countries, protect specific jobs for specific workers in the short run. However, they discourage workers who have protected jobs from seeking new jobs in which their social product (if not immediately their own income) would be higher. They also discourage creation of new jobs by making prospective employers fear that workers hired to expand output today will be a liability if demand contracts tomorrow.

Distortions also arise from controls on interest rates and credit allocations, especially in inflationary economies. Several developing countries have controlled nominal interest rates on deposits at financial institutions in the face of inflation rates that made real returns of such deposits substantially negative. This discouraged saving and investment and impaired the functioning of financial institutions as intermediaries of credit transactions. When real rates of return on savings were well below those on investment, financial institutions typically employed nonprice mechanisms for allocating the scarce supply of credit. Many factors other than the likely economic productivity of alternative investments can influence the allocation of credit in such an environment.

In its continuing studies of the effects of economic policies on economic growth, the World Bank has estimated for a number of developing countries the extent of economic distortions resulting from inappropriate exchange rates, protection of domestic manufacturing industries from import competition, protection or taxation of domestic agriculture, distortions of domestic capital markets, distortions of domestic labor markets, and distortions generated by inflation. The measures of these classes of distortions have been combined in a general distortion index, which has been related to measures of economic performance of developing countries in the 1970s. The results are summarized in Table 2-5. Countries with a low distortion index show a higher growth rate of real gross domestic product, a higher domestic savings ratio, a higher growth rate of industrial output, a higher growth rate of agricultural output, and a higher growth rate of exports than countries with a medium distortion index. Medium-dis-

tortion countries, in turn, show better economic performance in all of these categories than countries with a high distortion index.

TABLE 2-5.—*Price distortions and economic growth in the 1970s*

[Percent[1]]

Country category	Annual growth rate of GDP	Domestic saving/GDP ratio	Return on investment	Annual growth rate of agriculture	Annual growth rate of industry	Annual growth rate of export volume
Low-distortion countries	6.8	21.4	27.6	4.4	9.1	6.7
Medium-distortion countries	5.7	17.8	26.9	2.9	6.8	3.9
High-distortion countries	3.1	13.8	16.8	1.8	3.2	.7

[1] Averaged across countries.

Source: International Bank for Reconstruction and Development, *World Development Report, 1983.*

MAINTAINING POLITICAL STABILITY

A final general lesson from the growth experiences of many countries over a long span of time is the importance of maintaining reasonable political and economic stability. Economic growth requires current sacrifice to obtain future reward. A political and economic system that does not provide reasonable assurance that those who make the sacrifices will enjoy a fair share of the reward will almost inevitably fail to generate much growth. This is apparent in countries where the insecurity created by war or political turmoil has caused economic stagnation or decline.

Even in less extreme circumstances, it is important that the political and economic system provide reasonable assurance that those who make the greatest contributions to economic progress enjoy a fair share of the fruits of that progress. This means that there is unlikely to be an absolutely even distribution of the benefits of economic growth. Those who work the hardest, save the most, exhibit the greatest skill and inventiveness, and provide the critical entrepreneurial efforts should be able to expect a greater share in the benefits of growth than those who make smaller contributions. On the other hand, economic "progress" that benefits only a very few, perhaps at the expense of a great many, is likely to prove unstable and ephemeral. Sustained economic growth requires the contributions of all elements of society and should be expected to benefit all elements of society.

The broad experience with economic growth and development over the past three decades demonstrates that rapid economic growth does benefit all of society, even if all do not benefit in the same proportion. A developing country that has enjoyed the average growth of real per capita income over the past three decades has more than doubled its real living standard. In some countries with average or

better than average growth rates, real per capita incomes of the poorest 20 percent of the population may have risen relatively less than real per capita incomes of the richest 20 percent of the population. But even the poorest 20 percent have benefited substantially from general economic growth. Along the coastline of economic progress the tide may rise more rapidly in some places than in others, but, as President Kennedy observed, "A rising tide lifts all boats."

There is, of course, no absolute guarantee that countries will always achieve rapid rates of economic growth even if their governments recognize the importance of economic incentives, maintain reasonable fiscal discipline, sustain moderate inflation rates, pursue open policies with respect to international trade, keep exchange rates near economically appropriate levels, avoid excessive distortions of their domestic economies, and provide reasonable assurance that those who make the sacrifices necessary for economic progress enjoy a fair share of the benefits of such progress. At times adverse external economic conditions will make growth difficult even for countries with growth-oriented economic policies. Moreover, in the final analysis, successful growth and development do not depend only or primarily on government policies. They depend on the effort, investment, ingenuity, and enterpreneurship of the citizens of a country. The fundamental task for economic policy is to provide the essential environment of economic stability and the right framework of economic incentives so that these basic forces can have their full effect in generating economic progress. The experience of many developed and developing countries indicates that in the longer run societies where economic policies perform these essential tasks do enjoy the fruits of economic progress and the improvements in human welfare that flow from such progress.

POLICIES FOR THE INDUSTRIAL COUNTRIES AND THE INTERNATIONAL ECONOMIC SYSTEM

Developing countries operate in an economic environment influenced by the economic performance and policies of the industrial countries and by the international system that guides economic relationships among nations. The industrial countries contribute to successful economic performance of developing countries by maintaining rapid and sustainable rates of economic growth and reasonable price stability, and by supporting an open system of international trade and investment that serves the interests of all nations.

POLICIES OF THE ADMINISTRATION

The Administration has directed its economic policies toward these fundamental goals. The Administration has sought a monetary policy that reduces the inflation rate gradually from the high rate it inherited in 1981 to the moderate rates experienced over the past 3 years and ultimately to the zero rate consistent with price stability. The Administration has pursued a tax policy that reduces marginal tax rates in order to strengthen incentives for productivity and growth. The Administration is actively seeking additional tax reform that will further reduce marginal tax rates and equalize tax treatment of different forms of investment, again with the objective of supporting more rapid economic growth. To increase the efficiency of resource use, the Administration has reduced the burden of government regulation and is pursuing further deregulation. The Administration has opposed protectionist measures that conflict with the basic principles of an open system of international trade and has sought to persuade other nations to adopt more open trade policies. In cooperation with other nations, the Administration has pursued efforts to strengthen the international financial system and has recently proposed new initiatives in this important area.

As discussed in detail in Chapter 1, under Administration policies, the United States has enjoyed a sharp decline in inflation and a robust recovery from the world recession of 1980–82. In the other industrial countries, inflation rates also generally are down substantially from the high levels prevailing in 1979–81, but recovery from the world recession has been sluggish. In many industrial countries, unemployment rates have risen to levels not experienced since the 1930s. Fortunately, recent evidence suggests that unemployment rates in many of these countries have peaked and that future growth will at least keep them from rising.

POLICIES TO REDUCE STRUCTURAL RIGIDITIES

One favorable sign of the prospects for more rapid and sustainable growth in the industrial countries is the increasing consensus that to deal with chronic problems of slow growth and high unemployment, structural rigidities (especially in labor markets) must be reduced. In part, this is a task for government. Explicit or implicit subsidies to provide public services at artificially low prices or to maintain high-wage jobs in unprofitable industries must ultimately be financed by taxes that tend to reduce employment, investment, and growth in other industries. The same is true of overly generous benefits to unemployed workers, which may also reduce incentives for finding new employment. Restrictions on plant closing or work force reductions may, in the short run, diminish chances of unemployment for work-

ers with jobs, but they probably also discourage new and existing firms from hiring more workers. The net result in the longer term is likely to be a less efficient distribution of the labor force and a lower level of total employment. Low-rent public housing and other heavily subsidized public services linked to residency in a particular area discourage labor mobility. Reform of these and other government policies that contribute to rigidities and inefficiencies of the economic system can contribute importantly to renewed growth.

From a broader perspective, the problem of structural rigidities must be addressed by all who participate in the economy and in the political system. The process of economic growth is not one in which each forward step benefits everyone or, at a minimum, harms no one. In a prosperous and growing economy, some industries expand while others contract. Some firms grow and earn above-average profits while others decline and confront bankruptcy. Some workers enjoy rapid increases in real wage rates and work overtime hours while others face real wage declines or unemployment. In the end, rigid insistence that such disparities should not exist is tantamount to insistence that rapid economic growth should not occur. The whole, vastly favorable experience with rapid economic growth in the postwar period demonstrates the error of such a posture. There is much to gain from reaching the social, political, and economic consensus necessary to move away from such a posture and toward more growth-oriented economic and social policies.

POLICIES FOR THE MULTILATERAL DEVELOPMENT BANKS

The recent and continuing problems of a number of heavily indebted developing countries suggest the desirability of further efforts to improve the international financial system. In considering these improvements, it is important to distinguish between the system of official lending and assistance, bilateral and multilateral, that serves the financial needs of both low- and middle-income developing countries, and the system of private lending and direct investment that supplies external capital primarily to middle-income developing countries. Given the problems that private creditors have recently experienced with loans to middle-income developing countries, it seems unlikely that private capital flows will anytime soon become the dominant source of external credit to low-income countries.

The Multilateral Development Banks (MDBs) are an important source of external credit and technical assistance to developing countries. The MDBs include the World Bank and its affiliates, the Inter-American Development Bank, the Asian Development Bank, and the African Development Bank. Aggregate new MDB loan commitments to both low- and middle-income developing countries cur-

rently run about $20 billion per year. MDBs loan to low-income countries on a concessionary basis, while they loan to middle-income countries at or near market interest rates.

MDB loans are concentrated in areas for which it would be difficult to attract private external credit, including agricultural development projects, education, health, transportation, and water and sanitation systems. MDBs also frequently provide technical assistance on project design and operation to countries with shortages of skilled personnel, and they help to catalyze resource flows to developing countries from private sources. To continue these generally worthwhile activities, it is necessary for the industrial countries to provide continued support to the MDBs, especially for their concessional lending activities. To serve these same ends, the United States has suggested that reflows to the IMF Trust Fund (estimated to be $2.7 billion over the next few years) be used to provide additional assistance to low-income countries pursuing policies to restructure their economies and improve prospects for growth.

MDB lending for industrial development projects and other projects that could be run as business enterprises (including some projects in the agricultural sector) raises issues that need to be carefully analyzed. A loan to finance a business investment is justified if that business can reasonably be expected to generate profits sufficient to repay the loan at an interest rate that appropriately reflects the scarcity value of capital. The scarcity value of capital in low-income developing countries is not the interest rate that MDBs charge on concessional loans, but rather is an interest rate that probably exceeds the rates charged on nonconcessional loans from these institutions. Moreover, in assessing the potential profitability of a prospective business investment, it is important to use appropriate "shadow pricing" techniques so that profitability is not artificially inflated by government policies that provide special privileges to a particular enterprise. For example, a textile mill or a fertilizer plant that is profitable only because a tariff protects it against competing imported products is not a worthwhile investment project based on an appropriate cost-benefit calculation.

MDBs also engage in "structural adjustment lending" to facilitate adoption of economic policies that provide a better environment for economic growth in the longer term but have significant costs in the short term. With respect to such lending, it is critical that the policies really do provide a better environment for economic growth and that these policies be implemented and maintained. Even for the poorest countries, additional resources made available through external loans do little long-run good if economic policies do not create an environment conducive to economic growth.

For most of the middle-income developing countries that have been the focus of the international debt crisis, lending from MDBs and other official sources has provided a relatively small part of external credit. Much of the external credit to countries involved in the debt crisis has come from private sources, especially from commercial banks in the developed countries. A key element in the problems of these countries has been the decline in confidence of their creditors concerning their ability to meet their debt-service obligations. These doubts affected not only foreign creditors who became reluctant to extend new loans or extend the terms of existing loans, but also domestic investors who sought safer foreign havens for their capital.

The key requirement for resolving the problems of these debtor nations is their adoption of economic policies that support sustainable growth and structural adjustment and afford to their creditors (foreign and domestic) confidence of receiving a fair rate of return on their capital. Absent such a return of confidence, based upon a genuine improvement in prospects for future economic growth, further extensions of credit from external sources, official or private, are at best a short-run palliative. If domestic residents cannot be persuaded to keep their capital at home and return some that they have moved abroad, there is little hope that foreign investors can be induced to fill the gap for very long.

The industrial countries, including the United States, can make a substantial contribution to resolving the problems of the debtor countries by supporting an environment conducive to the economic growth of developing countries. This means maintaining rapid and sustainable rates of economic growth and reasonable price stability in the industrial countries, and supporting an open international economic system that allows developing countries to grow and to meet their external obligations.

In addition, the industrial countries recognize that debtor countries pursuing appropriate policies supportive of economic growth and balance of payments adjustment require access to external credit adequate to finance implementation of these policies. Specifically, at the Williamsburg Summit in 1983 and the London Summit in 1984, the six major industrial countries agreed that the problems of debtor countries need to be addressed on a case-by-case basis in accord with the following principles: (1) Debtor countries need to adopt policies that will adjust their economies to the realities of their external payments situations. (2) Sustained growth and maintenance of open markets in the industrial countries are important for the successful resolution of the problems of many debtor countries. (3) The IMF should

have adequate resources to play its important role in providing credit and arranging programs for stabilization and adjustment in debtor countries. (4) Continued commercial bank lending is necessary and appropriate for countries making determined adjustment efforts. (5) Bridge financing from central banks should be provided when necessary to facilitate agreement on suitable adjustment programs.

More recently, at the IMF/World Bank Annual Meeting in Seoul in October 1985, the U.S. Secretary of the Treasury, proposed a Program for Sustained Growth that builds upon the principles established at the economic summits to foster growth and adjustment of developing countries. The program embodies three main elements: adoption by debtor countries of macroeconomic and microeconomic policies to promote growth, reduce inflation, and secure balance of payments adjustment; continued central involvement of the IMF in the arrangement of stabilization and adjustment programs, supplemented by structural and sectoral assistance lending by the multilateral development banks; and increased lending by commercial banks. The program calls for a 50 percent increase in loan disbursements by the MDBs and for $20 billion of new loan commitments by commercial banks to a core group of 15 debtor nations over the next several years. These disbursements and loans will be tied to comprehensive economic reforms by the borrowers and to continued commercial bank lending to other developing countries that pursue appropriate policies.

Additional commercial bank lending will be required over the next few years to meet the financing needs of debtor countries pursuing appropriate policies. In the longer term, however, it would be desirable to reduce problems arising from the mismatch between the nature of the investment undertaken by developing countries and the nature of the external obligations issued to finance part of this investment. Developing countries have financed long-term equity investments in their own economies with short-term, foreign-currency-denominated, government-guaranteed, floating-interest-rate loans from large international commercial banks. If these bank loans had instead taken the form of equity investments, like common stocks, the effect of the adverse developments of the early 1980s would have been partly absorbed by foreign holders of these equities. If bank loans to developing countries had instead taken the form of long-term bonds, then at least the effect of the increase in market interest rates would have been absorbed by the bondholders in the form of a decline in the market value of their bonds. In addition, if the bonds were not government guaranteed, then the bondholders would have absorbed the increase in default risk associated with a deterioration in economic conditions.

Of course, potential foreign investors would require higher expected rates of return to compensate for the increased risks associated with equity investments or long-term, nonguaranteed bonds. A developing country that seeks to finance part of the expenses of its growth with foreign capital simply must decide whether it wishes to pay a higher expected return to foreign investors to induce them to bear part of the risk inevitably associated with any economic endeavor, or whether it wishes to absorb all the risk itself and pay a lower, but fully assured, return to foreign investors. It is relevant to note that most of the capital inflow into the United States in the 19th century took the form of foreign investments in securities issued by private sector enterprises, especially railroad bonds. Holders of these securities were exposed to some risk from interest rate fluctuations and from the possibility of default, but presumably were offered returns that compensated for these risks.

To encourage an appropriate share of equity investment in total credit flows to developing countries, it is important that creditor countries avoid policies that distort the nature of these credit flows. These distortionary policies include restrictions on foreign investment adopted in misguided efforts to protect domestic jobs. It is also especially important that developing countries desiring increased equity investment create an environment favorable to such investment. National treatment of foreign firms and investors (that is, treatment on the same basis as domestic firms and investors) generally contributes to such an environment. In contrast, differential taxation of domestic and foreign investors or enterprises, special limitations on the activities of foreign-owned firms, restrictions on repatriation of earnings, export performance requirements, insistence on domestic participation in or control over subsidiaries of foreign enterprises, and inadequate protection of patents, licenses, and intellectual property rights generally do not support such an environment.

POLICIES TO STRENGTHEN THE OPEN SYSTEM OF TRADE

In the area of international trade policy, there is the need to forestall new efforts at protectionism and to roll back protectionist measures in both developed and developing countries. The next chapter discusses the fallacies in arguments used to support protectionism. Here, it is important to stress the essential link between an open world trading system and the ability of many developing countries to meet their external payment obligations. Payment of just the interest on the external debts of indebted developing countries, without any new net borrowing, currently requires that these countries generate payments surpluses (primarily from net exports) of about $80 billion per year. Even with a substantial flow of new net lending, payment of

a significant fraction of the interest on already outstanding loans requires that indebted developing countries generate substantial net export surpluses. Generation of such surpluses depends on the ability of debtor countries to sell their products in the markets of creditor countries.

Opposition to protectionism and support of the open system of world trade is in the community interest of all nations. In most countries, from time to time, strong political pressures arise to adopt protectionist measures that serve the interests of special groups, even though they do not serve the general interest. The ability to resist such pressures is strengthened when the international ethic supporting an open trading system is strong, and is weakened when other governments yield to special interests or adopt protectionist measures for other misguided reasons.

In this regard, the role of developing countries should not be ignored. Most rapidly growing developing countries have benefited substantially from the open system of international trade and investment. They have not, however, always been assiduous in abiding by the rules and adopting the ethic of that system. This is true not only for trade policies, where some developing countries have ignored or claimed exemption from the rules of the General Agreement on Tariffs and Trade, but also for important issues like the rules governing foreign investment and protection of patents and intellectual property rights. Such lapses once received little attention. As the economic importance of these countries grows, these lapses pose an increasing threat to the open system of international economic relations.

The extraordinary postwar record of economic progress under this open system of international trade and investment demonstrates the substantial benefits that this system provides to all nations. The United States, as the principal sponsor and supporter of this system, has a special interest in, and responsibility for, its preservation and improvement. Other nations, including many developing nations that have progressed rapidly under this open international economic system, share this interest and responsibility.