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Members will find attached the text of the World Bank background paper on "External debt, trade and the international environment".

(Note: this document exists in English only)

Directorate-General for Committees
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USA Background

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EXTERNAL DEBT, TRADE AND THE INTERNATIONAL ENVIRONMENT

World Bank background paper

Washington -- Experience has shown that those developing countries which adopt long-term adjustment programs tailored to their own individual needs can expect increased growth in domestic productivity, income and foreign private capital flows.

So concludes a background paper presented by Anne Krueger, World Bank vice president for economics and research, at the annual meetings of the Bank and International Monetary Fund September 26.

"If the world economy continues at its present rate of growth and especially if real interest rates do not increase," the paper says, "we shall hear less about the debt problems of developing countries in the years to come as more and more of them succeed with development enough to shift reliance to private capital markets."

Following is the text of the World Bank background paper:

After three years of generally declining income growth and trade, the international economy has begun to grow again. This resumption of growth provides a basis for cautious optimism about prospects for world prosperity. Growth rates in 1984 are likely to be much higher than in 1983, both in the industrial and developing countries. The average GNP (gross national product) growth rate will reach four percent in industrial countries in 1984 compared to 2.4 percent in 1983. For the developing countries the improvement will be even greater from two percent in 1983 to 3.5 percent in 1984. The pace of economic expansion has been especially promising in the United States and in a number of developing countries which pursued more prudent macroeconomic policies, avoided excessive borrowing, and maintained more outward-oriented trade policies in the 1970s and early 1980s.

It is necessary at this juncture to examine what efforts are needed to lay the foundation for sustained long-term growth in those developing countries which are now doing well and to spread growth to other which continue to face difficult challenges. There are two groups of developing countries whose future growth prospects are a cause for concern: The poorest countries in sub-Saharan Africa and a number of middle-income countries especially in Latin America that have been experiencing debt servicing difficulties. The Bank's Sub-Saharan Report has presented our views on the many steps that need to be taken to address the complex problems of the African countries. I will focus my attention on the debt issue in both middle-income and low-income countries.

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I must stress first that there is no single "debt problem"; circumstances differ from country to country depending on economic characteristics and its policies. Nor is there a single solution to the debt problems. Media attention has focused on the situation of the large, middle income debtors primarily in Latin America, although many sub-Saharan African countries are experiencing equally, if not more severe hardship, in servicing their debt. The character of the debt servicing difficulties among countries differs according to their per capita income levels, sources of finance, and the nature of their debt obligations. Middle-income Latin American countries' debt problems differ from those of Africa. The latter's low level of development makes it hard to service debt on commercial terms. It also makes adjustment measures more difficult to implement.

Keeping these distinctions in mind, it is useful to divide the evolution of debt problems into the following stages:

The first stage of the problem was characterized by emergence of debt servicing difficulties in a number of countries highlighted by the Mexican experience in the summer of 1982. International cooperation, led by the IMF (International Monetary Fund), and with the participation of other bilateral and multilateral institutions, allowed a crisis to be averted. This was the appropriate action and it demonstrated the speed with which crisis management can be handled when interests of countries converge.

That led to the second stage in which macroeconomic adjustment, mainly in the form of reduction of excess demand, is taking place in most debtor countries at an aggregate level. Recent data indicate that the difficult adjustment process initiated in developing countries is beginning to work. According to World Bank estimates, the combined balance of payments current account deficit of non-oil developing countries decreased by 50 percent over the 1981-1983 period. In absolute terms the combined current account deficit of developing countries is projected to fall further from 57,600 million dollars in 1983 to 51,600 million dollars in 1984 and to 49,800 million dollars in 1985. This does not mean, however, that all countries are adjusting well or easily. The past five years have been traumatic for many of these countries in terms of consumption reduction, compression of imports, and high unemployment. The macroeconomic adjustments that have taken place have been primarily through income contraction rather than by increasing productivity and efficiency of resource use. The need now is to move beyond this stage to a new stage in which long-term growth is resumed.

The success of this new third stage will depend on the policy steps taken by the developing countries themselves and the conditions that will prevail in the international environment.

Developing countries' long-term adjustment programs need to be tailored to each country's particular circumstances. But there are some common elements which require special attention. These include: adopting realistic exchange rates; eliminating quantitative controls and regulations of imports and exports; increasing efficiency of public sector investment programs; evening out the dispersion of incentives both among and within industries and particularly between production for export and for the domestic market and between industry and agriculture; and encouraging domestic savings by reducing government deficits and increasing the return to private savers. Experience has shown that countries which adopt such policies can expect increased growth in productivity and income. Were such growth to start, it will raise lender confidence and encourage the resumption of foreign private capital flows and investment.

Many of these policies will be politically difficult to implement. Liberalization of trade regimes is always difficult because of the entrenched interests that protection creates. Coming out of a prolonged period of income contraction, it is also politically difficult to divert relatively more resources from consumption to investment.

Adjustment efforts would be obviously easier with additional finance to increase levels of imports and more fully utilize existing capacity. It is thus essential that commercial banks increase their lending to countries which take effective steps to improve their long-term growth prospects.

While addressing the long-term growth and resumption of creditworthiness, developing countries need to be mindful of two aspects of financing. First, an important lesson of the 1970s is that increased attention will have to be paid to the maturity structure of the debt. Currently, over 70 percent of the principal on the outstanding medium- and long-term public and publicly guaranteed debt of the developing countries is scheduled to be repaid by the end of 1987.

Second, developing countries may wish to reconsider their earlier preference for borrowing over equity foreign investment. The latter imply a very different sharing of risks from that entailed in borrowing or bond financing: When earnings decline (for whatever reason), interest payments on debt nonetheless continue. When equity capital is involved, reduced earnings imply reduced financing obligations.

If countries are to move to this next stage, it is also necessary that the international environment be congenial to their adjustment efforts. The following aspects of the international environment need particular attention.

First, export expansion is a critical need for developing countries facing debt servicing difficulties. Given that the current debt servicing ratios of some countries are too high, an increase in creditworthiness requires that these ratios be reduced. If interest rates remain at present levels, the debt-service ratio can fall either because the rate of growth of foreign exchange receipts increases or because countries suppress their imports so much that their current accounts improve despite stagnant economies. Further generation of foreign exchange through import compression will retard growth and may be politically unacceptable in many countries. Expansion of world trade and increased market access is therefore essential for the resolution of debt problems. For a robust expansion of trade to take place, protectionist pressures have to be reduced. The current recovery may be expected to reduce protectionist pressures stimulated by the recession. Unfortunately, to date although many industrial countries in different fora have made statements that they will resist protection and protectionist pressures, they have taken few concrete steps to liberalize trade. Trade liberalization will be helpful to their own growth prospects, but will be politically difficult to implement on a unilateral basis. Thus, a new round of multilateral negotiations must be initiated and utilized as a weapon to reduce protection. An agenda for meaningful negotiations must include discussions on textiles, agriculture products, and more labor-intensive manufactures, all items of interest to developing countries. A new round must focus on dismantling non-tariff barriers and solicit full participation from developing countries. A clear commitment by developed countries to initiate the negotiations is necessary to allay the fears of developing countries that such a negotiation will leave them no better off than before.

Second, non-inflationary growth in the industrial countries with a return to historical levels in real interest rates would be another important ingredient in the adjustment process of debtor countries. Growth in industrial countries will obviously stimulate exports. To the extent that it is accomplished through a macroeconomic policy mix that reduces real interest rates, that growth will be doubly beneficial to debtor countries.

Third, during this third stage adjustment efforts have to be supported by adequate financial flows to sustain the adjustments by longer term rescheduling of existing liabilities. In part, these financial resources will be forthcoming from the private sector if developing countries pursue appropriate policies. In many cases, however, they need to be augmented by support from the international financial institutions.

Finally, in the case of low income countries such as in sub-Saharan Africa, the need is for additional concessional assistance from the major donors; even in the medium term, the capacity of these countries to service non-concessional capital inflows will be extremely limited.

If the world economy continues its present rate of growth and especially if real interest rates do not increase, we shall hear less about the debt problems of developing countries in the years to come as more and more of them succeed with development enough to shift reliance to private capital markets. That would be a symptom of success in development. But this success will not come about without significant improvements in the policies of both industrial and developing countries.

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