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Priority Issues for the World Economy

by
A.W. Clausen†

As we enter the last half of 1984, recovery from the worst recession in fifty years is underway in the industrial countries. In global terms, however, the recovery remains very uneven.

United States economic recovery continues strong with 5% real growth likely in 1984, while Japan's growth may come close to 4%. European recovery is more sluggish, with economic expansion likely to increase at less than a 2% real rate. Overall, the industrial nations should experience average growth of about 3.6% in 1984.¹

The developing countries, on the other hand, remain in a very difficult situation. The World Bank estimates that the average growth rate of these countries will amount to 3–3.5% in 1984, up from about 1% in 1983 and from less than 2% in 1982.² With annual population growth at more than 2% in the developing countries, however, average per capita income will increase only minimally, after having decreased in 1982 and 1983.³ Meanwhile, the total debt of developing countries increased from \$810 billion in 1983 and \$766 billion in 1982.⁴ The costs of servicing this debt exceeded the amount of new loans in 1983. The economic problems of the developing countries thus continue in stark contrast to the economic progress experienced elsewhere.

The world economy now stands at a crossroad. The challenge presented involves two complementary objectives: a sustainable, non-inflationary recovery of the industrial world's economies and a revival of economic growth in the developing countries. The pace of the recovery of the industrial nations is indeed encouraging, but the prospect for sustained global recovery depends on four major economic issues which must receive priority attention in 1984 and for some years to come. These issues are: (1) improving economic policy and performance in the industrial countries; (2)

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1. INTERNATIONAL MONETARY FUND, *WORLD ECONOMIC OUTLOOK: A SURVEY BY THE STAFF OF THE INTERNATIONAL MONETARY FUND* 169 (1984).

2. THE WORLD BANK, *WORLD DEVELOPMENT REPORT 1984* at 11.

3. THE WORLD BANK, *1984 ANNUAL REPORT* 33.

4. INTERNATIONAL MONETARY FUND, *supra* note 1, at 205.

liberalizing and expanding trade; (3) reviving international capital flows; and (4) improving economic policy in the developing countries.

I INDUSTRIAL COUNTRY POLICY AND PERFORMANCE IMPROVEMENTS

Maintenance of the recovery in the industrial countries depends on several specific steps. Reducing budget deficits, especially in the United States, and increasing employment represent essential ways of maintaining the recovery's momentum. Real interest rates continue at high levels, and the prospect of annual U.S. deficits on the order of \$200 billion over the next few years may well keep upward pressure on interest rates, dampen business confidence, and increase unemployment.⁵

In order to move from recovery into a sustained period of economic expansion, the industrial countries also need to create an environment conducive to structural change. Economic progress requires change, such as employing new technologies to increase productivity or adapting old economic structures to evolving patterns of comparative advantage. Adaptation in the industrial countries, particularly in sectors such as steel and textiles, has failed to keep up with the need for change over the past ten years. This failure has contributed to falling returns on investment and to declining rates of growth. A new period of sustained growth will require policies in the industrial countries that permit and facilitate the ongoing changes necessary to raise productivity levels.

II TRADE LIBERALIZATION AND EXPANSION

The industrial countries will not be able to achieve sustained and rapid growth of their own economies, much less stimulate global recovery, on the basis of purely domestic improvements. Global recovery requires attention to another priority issue—liberalization and expansion of international trade.

For most of the period since the Second World War, an increasingly open trading environment has encouraged trade to grow faster than production, with benefits for both developed and developing countries. Trade liberalization represented a powerful stimulus to Western Europe's economic recovery and growth. Through trade the European economies transmitted this growth potential to the developing countries.⁶ In turn, the

5. See A.W. Clausen, Address Before the Economic Club of Detroit, Michigan 5-6 (May 23, 1984) (available from The World Bank).

6. From 1976 to 1982, exports of the industrial countries to the oil exporting and non-oil exporting developing countries grew from \$166 billion to \$333 billion. INTERNATIONAL MONETARY FUND, DIRECTION OF TRADE STATISTICS YEARBOOK 110 (1983). See also S. STUART, THE THIRD WORLD ECONOMIC HANDBOOK 11 (1982).

developing countries have become increasingly important as markets for the exports of industrial countries. If sustained global recovery is to occur, the nations of the world must adopt measures that will assure the continuation of this stimulative process.

The best way for developing countries to revive their economies—and the only way for indebted countries to overcome their current financial difficulties—is to expand exports. In order to achieve this expansion, these countries need increased access to major world markets. In recent years this access has declined at the same time that the foreign exchange requirements of the developing world have increased. Between 1970 and 1980, for example, export earnings of the developing countries increased by 140% in real terms.⁷ In contrast, between 1980 and 1983, export revenues of the developing countries stagnated, while debt-service payments (for medium- and long-term debt) increased by over \$25 billion.⁸

Most of the low-income countries rely heavily on agricultural products and other non-fuel commodities for their export earnings, but some industrial countries still block the importation of these goods.⁹ More generally, the prices of non-fuel commodities depend very much on economic conditions in the industrial countries and on the growth of the world economy as a whole. In addition, some of the low-income countries could begin to enter into the more promising markets for manufactured exports, but escalating tariffs and increasing non-tariff trade barriers often block the way.

Trade is a two way street, and developing countries provide a very significant market for exports from industrialized countries. As a whole, developing countries account for almost 30% by value of the exports from industrialized countries. More than 45% of Japan's exports go to developing countries. Over 40% of the U.S. foreign sales, more than 30% of Italy's exports, and almost 30% of the exports of France and Britain are destined for the markets of developing countries.¹⁰

The recent financial difficulties of the developing countries have, quite naturally, forced them to reduce these imports. Mexico, for example, reduced its imports by two-thirds between 1981 and 1983. The fall in the dollar value of Brazil's imports amounted to approximately 12% in 1982 and over 20% in 1983, on top of an earlier decline in 1981. Further, strenuous efforts to curb domestic consumption on the part of all developing countries resulted in a reduction of total imports from industrial countries

7. The World Bank estimates that ninety-three percent of this increase went to some sixty middle-income developing countries while only seven percent went to some thirty-five low-income developing countries where about one half of the world's population lives.

8. INTERNATIONAL MONETARY FUND, *supra* note 1, at 175, 209.

9. See WORLD DEVELOPMENT REPORT 1984, *supra* note 2 at 41.

10. Exports of the selected major industrial countries to oil exporting and non-oil exporting developing countries as a percentage of their total exports in 1982 were: France (29.6%), Italy (32%), Japan (45.5%), United Kingdom (27.7%), and the United States (40.9%). INTERNATIONAL MONETARY FUND, *supra* note 8, at 172, 228, 235, 396, 399.

of \$43 billion in the twelve month period ending in mid-1983. These necessary cuts had a substantial impact on the industrial nations. World Bank estimates indicate that the industrial countries could very well have achieved 3% real growth last year, rather than the 2.3% actually realized, if developing country imports had continued at the 1982 level.

A major problem facing global economic recovery today is the threat of protectionism. If new trade barriers are erected and existing ones increased, it will adversely affect the growth and development prospects of all countries. The current pressures for protection are partly provoked by conditions of recession. More protection, however, will prolong and worsen the recession by discouraging production in other countries and by making the protected economy less efficient for years to come.¹¹

More liberalized trade, on the other hand, can help the world economy escape the stop-and-go between recession and inflation that has hampered sustained growth in recent years. Protection allows a country to postpone difficult adjustments to changes in international comparative advantage, but only at the cost of increased inefficiency and damage to the protected economy. Conversely, free trade fosters necessary adjustments, growth and, therefore, jobs and higher incomes. At the same time, free trade tends to restrain inflation by encouraging price competition. The overall benefits that a nation gains from free trade are more than enough to cover the costs of assisting those people who are hurt by international competition to move, if possible, into industries with better prospects.

Some advocates for protection attempt to revive discredited arguments by using the new terminology of "managed trade".¹² "Managed trade", however, is just one more name for government intervention to shelter non-competitive industries. "Managed trade" locks labor and capital into less productive sectors, strengthens inflationary pressures, and starves dynamic industries of needed resources. Businesses must face the pressures of the global marketplace, rather than run for cover behind protectionist walls.

The way in which industrial countries handle protectionism carries dramatic implications for the Third World. If developed countries grow at about 3.3% during the remainder of this decade, an attainable level, and if protectionism is held in check, then the exports of developing countries may well grow at about 5-6% per year in real terms. This rate of growth represents sound progress, although it reflects a decline from rates in the 1960s and 1970s. Such a rate of expansion for Third World exports is necessary if these countries are successfully to manage debt servicing and ultimately earn their way out of balance-of-payments difficulties. If developing coun-

11. WORLD DEVELOPMENT REPORT 1984, *supra* note 2, at 40-41.

12. "Managed trade" has been defined as "trade that is subject to some non-tariff control." Page, *The Management of International Trade* in BRITAIN'S TRADE AND EXCHANGE RATE POLICY 166 (R. Major ed. 1979). See also D. Greenaway, TRADE POLICY AND THE NEW PROTECTIONISM 168, 171 (1983).

tries run up against a brick wall of protectionism, however, their chances for even servicing their debt appear remote indeed.

In order to avoid the ill effects of protectionism and to reap the benefits of trade, the industrial countries should welcome competitive imports from developing countries and allow their own resources to be gradually reallocated to reflect shifts in comparative advantage. The significant differences in production costs between industrial and developing countries offer a powerful opportunity to stimulate economic efficiency and higher real incomes on both sides through trade. Adjustment can be painful, but it is difficult to imagine how the industrial countries can return to a pattern of sustained economic expansion without such stimulation from the developing countries. Today's newly industrializing countries must gradually move up the scale of manufacturing sophistication, allowing the next rung of developing countries to become increasingly competitive in simpler, more labor-intensive lines of manufacturing. Barriers to imports from the developing countries frustrate this dynamic process.

At the same time, there is no question that many developing nations must also make major economic policy adjustments. Several newly industrializing countries have become quite successful trade performers, and the rest of the world might be able to learn from their approach.¹³ These countries adopted trade-oriented domestic policies because they recognized the benefits that they would gain by encouraging trade. Trade-oriented policies include realistic exchange rates, equal incentives for domestic and export production, and a willingness to permit import competition. Such policies improve resource allocation, boost growth, and make the countries which adopt them better able to withstand external shocks. The newly industrializing countries provide some of the most dramatic examples of how exports, if properly managed, can stimulate rapid growth.

The World Bank is striving to assist in the achievement of such necessary changes for all developing countries. As in the industrial nations, many developing nations must reduce protectionist barriers and adopt more open trade policies. The World Bank encourages all of its developing member nations to adopt liberal trade policies, even under adverse world conditions, because experience shows that trade by developing countries contributes to their own development, and that the benefits of trade far exceed the costs.¹⁴ Complementary initiatives by both developing and industrial countries to strengthen the open, multilateral trading system are essential to improved economic prospects for all countries.

13. See generally Riedel, *Trade as the Engine of Growth in Developing Countries Revisited*, 94 *ECON. J.* 373 (1984).

14. *WORLD DEVELOPMENT REPORT 1984*, *supra* note 2, at 44. See also 3 A.O. KREUGER, *TRADE AND EMPLOYMENT IN DEVELOPING COUNTRIES: SYNTHESIS AND CONCLUSIONS* 43-54 (1983).

III

REVIVAL OF INTERNATIONAL CAPITAL FLOWS

Inextricably linked to trade expansion is the third priority for global recovery: reviving international capital flows. The total debt in 1983 (including short-term debt) of the developing countries amounted to \$810 billion.¹⁵ Since mid-1982, some thirty countries have renegotiated terms on as much as \$100 billion of this debt. These reschedulings, together with arrears and lower payments, have continued to increase. At the same time, new commercial-bank lending to developing countries, especially to major borrowers, has fallen dramatically. As a result, the net transfer (new lending minus debt-service payments) from commercial banks to developing countries is now negative. Therefore, many developing countries have been making greater efforts to attract direct investment by multinational corporations. Such investment, nevertheless, also shows a significant decline—from \$14 billion in 1981, to \$13 billion in 1982, to \$10 billion in 1983.¹⁶

Total disbursements of medium- and long-term credits fell to \$85 billion in 1983, which represents a decline of 15% and 27% from 1982 and 1981, respectively. This decline in disbursements resulted in reductions in net flows (disbursements after principal payments) and in net transfers (net flows after interest payments). Net flows in 1982 were 95% of the 1980 level, while net transfers dropped to only 27% of the level reached in 1980. These declines occurred largely because of the sharp fall in new commercial lending to developing countries. Other types of medium- and long-term capital flows (from official sources) have not grown to compensate for this reduction in medium- and long-term commercial bank lending.

The two main types of medium- and long-term capital available from official sources are non-concessional lending and development assistance. Medium- and long-term non-concessional lending comprises loans by The World Bank, the other multilateral banks, and export credit agencies.¹⁷ Development assistance comprises grants and highly concessional lending. The International Development Association (IDA), the World Bank's affiliate, is the largest multilateral source of concessional lending.¹⁸

Such official lending and development assistance could reduce the risks that worry commercial investors and dampen growth for developing coun-

15. INTERNATIONAL MONETARY FUND, *supra* note 1, at 205.

16. The World Bank estimates that these figures are net of reverse flows of equity, but they are not net of repatriation of profits.

17. International Monetary Fund resources are not included in this official lending category. The World Bank's non-concessional lending facilities include the International Bank for Reconstruction and Development and the International Finance Corporation; the other major multilateral development banks include the Inter-American Development Bank, the Asian Development Bank, and the African Development Bank. See generally E.S. MASON & R.E. ASHER, *THE WORLD BANK SINCE BRETTON WOODS* (1973); J. SYZ, *INTERNATIONAL DEVELOPMENT BANKS* (1974). See also U.S. TREASURY DEPARTMENT, *UNITED STATES PARTICIPATION IN THE MULTILATERAL DEVELOPMENT BANKS IN THE 1980s* (1982).

18. THE WORLD BANK, *IDA IN RETROSPECT 12-13* (1982).

tries. The World Bank, for example, helps developing countries establish a policy environment that is conducive to investment and growth. It also develops well-prepared and appraised projects which may be co-financed with commercial banks.¹⁹ Given the likely trends in other capital flows and the continuing need of the developing countries for medium- and long-term finance, growth in lending by The World Bank and the regional development banks is essential. The low-income developing countries (countries with annual per capita gross national product of \$795 or less in 1981 dollars), for example, depend on official development assistance for three-quarters of all the external capital they receive.

Evidence indicates, however, that the net transfer of medium- and long-term lending from official sources remained nearly constant between 1981 and 1983. Nor has any increase occurred in the flow of official development assistance. Although official lenders raise the bulk of their resources by borrowing in commercial markets, they need approved capital increases from the governments that control them in order to achieve any growth in lending.

The nations that contribute to IDA recently completed negotiating its funding level.²⁰ These nations agreed on \$9 billion over the next three year replenishment period, a sum much lower, even in nominal terms, than that agreed upon in 1979 for the last IDA replenishment. This turn of events unfortunately suggests flat growth of, or even a substantial reduction in, total official development assistance in the years ahead.

Concern in Europe, Japan, and North America about capital flows to the developing countries has focused primarily on the possible impact of the debt crisis on the international financial system. The financial system has held up thus far, but cutbacks in imports and government spending among the heavily indebted countries have created severe difficulties for their economies. Some developing countries used foreign borrowing to finance consumption rather than investment, particularly in the years immediately preceding the debt crisis of 1982.²¹ Those countries that borrowed, and postponed needed adjustments, must now undergo more abrupt adjustments.

All the parties to the debt problem including borrowing countries, commercial banks, industrial-country authorities, the Bank for International Settlements, the International Monetary Fund, and official lenders like The World Bank have worked together since 1982 to ameliorate the severity of the debt crisis. Financial cooperation between creditor and

19. See generally Silkenat, *The Role of International Development Institutions in International Project Financing: IBRD, IFC and Co-financing Techniques*, 17 INT'L LAW. 615 (1983); Note, *The World Bank's New Co-financing Initiatives: Legal Mechanisms for Promoting Commercial Lending to Developing Countries*, 15 LAW & POL'Y INT'L BUS. 911 (1983).

20. THE WORLD BANK, *supra* note 3, at 19-21.

21. WORLD DEVELOPMENT REPORT 1984, *supra* note 2, at 32-33.

debtor nations remains essential, not only in debt restructuring but also in stimulating capital flows to attain former levels of economic growth.

IV

DEVELOPING COUNTRY POLICY IMPROVEMENTS

Improved Third World economic policy represents a fourth priority in restoring the global economy and acts as an essential complement to liberalized trade, increased capital flows, and sustained economic recovery in the industrial world. The support that official development agencies provide for policy reform is one of their most valuable contributions, especially under current circumstances.

While the International Monetary Fund uses its resources to support policies designed to address balance-of-payments problems, The World Bank helps developing countries design and enact complementary reforms to foster a revival of economic and social development.²² Because such reforms entail difficult structural change and take time to come into effect, it is appropriate that The World Bank, together with other commercial and official lenders, provides assistance for this purpose.

The developing countries must tackle two problems. They must improve financial discipline to keep their balance-of-payments under control, while enacting additional policies to foster economic development and restored creditworthiness. For example, many governments must cut back on public spending, including public investment, to cope with immediate financial pressures. Concurrently, they should improve the quality of investment by using their remaining resources for only those projects that will have the greatest, most needed, and most productive impact.

Another way for countries to encourage economic growth over the medium-term involves allowing prices to reflect scarcity values. Price distortions retard economic growth, and many price distortions favor relatively privileged groups at the expense of lower-income people. In the 1960s and 1970s, several developing countries made major efforts to reduce price distortions, and, as a result, some of these countries sharply accelerated their economic growth. Such reform programs, however, proved complex, politically difficult, and not without short-term costs. This experience suggests the importance of reducing price distortions with determination, but gradually. While many developing countries have already taken impressive policy measures to improve their balance-of-payments position and to restructure their economies, the need to maintain political cohesion and stability often limits the speed of adjustment.

22. See I.S. Friedman, *Private Bank Conditionality: Comparison with the IMF and the World Bank* in IMF CONDITIONALITY 109-28 (J. Williamson ed. 1983). See also Gold, *The Relationship Between the International Monetary Fund and the World Bank*, 15 CREIGHTON L. REV. 499 (1982).

Finally, both the developed and the developing nations must increasingly strive to maintain and improve the international economic institutions that served the global economy so well over a generation of rapid growth and increasing interdependence. The GATT, the IMF, The World Bank and its affiliate, the International Finance Corporation, and the regional development banks must all be strengthened in order to help restore a healthy global economy.

In summary, the condition of the world economy in mid-1984 is more promising than a year ago. In order for a new era of sustained growth to be achieved worldwide, however, the developed countries must improve economic policies and performance, trade must be liberalized and expanded, both commercial and official capital flows must be increased, and the developing countries must improve their economic policies. The World Bank and other international institutions are, and must continue to be, a vital part of this global effort.