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Preface

The main themes discussed in these papers are, by common consent, among the most challenging facing the world economy as we approach the last decade of the twentieth century. They include the rapid erosion of national autonomy in many fields, and particularly in financial and economic policy, the unprecedented debt problems of many countries (including notably the United States) and what options are available to maintain growth in the developing countries and more generally recover the momentum of world economic development after a period that, for many, has been a Lost Decade

The three papers brought together in this publication had their origin in a Symposium on World Economic and Financial Crisis held on the occasion of the 31st Session of the Council of the United Nations University in Brasilia, Brazil, on June 28, 1988. Two of the papers were presented by their authors at the Symposium, and have been the subject of light editing only; these are the papers by Dr Masaru Yoshitomi, Director General of the Economic Research Institute of the Government of Japan and Dr Celso Furtado, Minister of Culture of Brazil. The third paper, by myself, is an expanded and revised version of off-the-cuff remarks made at the same occasion in immediate response to the two stimulating papers that had been presented.

This revised version was presented at the Development Policy Forum on Structural Changes in the World Economy and Development Cooperation in Tokyo on 25 October 1988, organized by the Sasakawa Peace Foundation.

Lal Jayawardena
July, 1989

RESOLVING THE WORLD'S TWIN DEBTS PROBLEM SIMULTANEOUSLY

Masaru YOSHITOMI

Introduction — the issues

The decade of the 1980s has witnessed the emergence of an historically unprecedented world twin debt problem. On the one hand, the key currency country, the U.S., incurred deficts averaging $150 billion annually on current account in 1986—87, and at the end of 1987, the U.S. net external position showed net liabilities of $370 billion or about 8 percent of GNP. On the other, the net external debt of "problem developing debtor countries" amounted to $670 billion, accounting for about 50 percent of GNP at the end of 1987. But such problem debtor countries have registered uninterrupted *surpluses* on the trade account since 1983, averaging about $28 billion surplus per annum. These are historically unprecedented features at least in the following two aspects. First, the key currency country has become a recipient of net real transfers from the rest of the world, whereas the problem developing debtor countries have been transferring net real resources. Second, the U.S. external deficit and developing countries' debt problem have emerged simultaneously since 1982. These world twin debt problems have been interrelated, suggesting that the problems can be effectively solved only if they are attacked simultaneously.

The nature of the problem, however, differs between the U.S. external deficit and the developing countries' debt. For the former, we began to see some consequences of the huge international payments imbalances of the U.S. in the form of financial turmoil including the stock market crash of October 1987. The essential policy target should be to avoid a dollar collapse by keeping the unwinding process of imbalances from being inflationary and also from generating high dollar interest rates. However, the international mechanism whereby adjustment discipline can be imposed on the key currency countries is bound to be different from the case of a non-key currency country. For the problem debtor developing countries, the thrust of policy measures is to hit a right balance between the burden of debt service on the one hand and increases in productive investment through reforming import-substitution policies on the other.

The purpose of this paper is threefold. First, the paper will briefly describe how the U.S. external deficit and the developing country

debt problem simultaneously emerged in the 1980s. Second, the paper will identify the basic features of the adjustment mechanisms of the developing countries' debt problem over the past five years and their outcomes. It will examine how and why the muddling-through adjustment process in 1982—87 resulted both in a lower investment ratio to GNP and in an almost uninterrupted rise of external debt/GNP ratios in the problem debtor countries. Third, the paper will turn to the main features of the external adjustment of the U.S. and Japan in 1986—87 and ask what is now needed for further adjustment. What will be the impact of the U.S. external deficit reduction on the developing country debt problem? In the concluding section, the paper will briefly discuss the policy measures of how to alleviate the world twin debt problem and what role Japan can and should play.

1. Interactions between the U.S. external deficit and the developing country debt problem.

The most striking feature of international payments imbalances in the first half of the 1980s is that the deterioration in the U.S. merchandise trade balance was *pervasive,* across both goods and countries.

The deterioration from 1981 to 1986 was uniform and proportionate, spreading across capital goods, automobiles (including parts) and consumption goods. Changes in the trade balance for these three end-use categories was almost perfectly proportional. That is, the magnitude of the actual deterioration of the trade balance in each category of $43—45 billion was almost exactly the same as what the trade balance of each category would have been if the 1981 proportions of each category to total imports and exports had been maintained unchanged (Table 1).

Similarly, the U.S. trade balance with each of its major trading partners deteriorated more or less proportionately. As a result, exports and imports of each trading partner as a share of U.S. total exports and imports remained largely unchanged from 1981 to 1986. For example, U.S. imports of manufactured goods from Japan accounted for 25 percent in 1981 and still 27 percent in 1986. Such imports from Europe accounted for 22 percent in 1981 and remained unchanged at 22 percent five years later. The U.S. deterioration with Asian newly industrializing economies (Asian NIEs or NICs) was also proportionate. The main disproportionate changes in the trade balance occurred with Canada in favour of the U.S., which was, however, more than offset by the disproportionate deterioration of the U.S. trade balance with developing countries, particularly with Latin American countries, as shown in Table 1.

This basic feature of the pervasive deterioration of the U.S. manufactured trade balance highlights three important issues. First

of all, the origin of the U.S. trade balance deterioration was macroeconomic in nature, rather than microeconomic. The origin was the combination of the excessive strength of the dollar against all other currencies prolonged over the medium-run from 1981 to 1985 and the strong domestic demand expansion supported by increasing large structural deficits of the U.S. government. Secondly, the disproportionately larger deterioration of $18 billion with Latin American countries reflected the severe external debt adjustment by the countries which substantially cut down imports. This was indicated by a sharp decline of the share of U.S. exports to such countries from 41 percent down to 32 percent, while the share of U.S. imports from Latin American countries remained almost unchanged. Thirdly, the macroeconomic combination of the strong dollar and the enlarged structural deficit of the U.S. government suggests that higher interest rates attracted foreign savings to finance both increasing domestic and external deficits of the U.S. While larger absorption in the U.S. helped an expansion of exports of Latin American economies, higher dollar interest rates tended to offset such beneficial effects through larger debt service.

A debt problem arises whenever the gap between interest payments that are due and the non-interest current account (or the primary current account) cannot be financed by voluntary, market determined new money. Three factors aggravate such a gap: (1) an increase in real interest rates, (2) a deterioration in the primary current account which is in turn due to shortfalls of exports, increases in imports often caused by mismanaged domestic economic policies in debtor countries and a worsening in the terms of trade and (3) decisions by creditor banks that their exposure has become excessive so that new money commitments should be limited and that maturing principal should be paid off instead of being rolled over. In 1982, almost all of these three factors simultaneously hit the Mexican economy and the international banking system itself was shaken. Since 1982 the world macroeconomic environment has shown some improvement but has not provided a setting in which the problem debtor countries could grow out of their debts by an export boom or better terms of trade. The simultaneous onset of the crisis in more than 40 developing countries which required emergency debt reschedulings provides good evidence that adverse developments occurred at the global level.

In sharp contrast, however, Asian middle-income developing countries except the Philippines achieved satisfactory economic performance. This contrasting performance after 1982 has highlighted three problems. (1) Heavily-indebted countries had a large handicap due to continued high real interest rates. (2) The debtor countries with heavy reliance on commodity exports suffered a terms of trade loss in 1983—86 due to decreases in commodity prices in real terms. (3) The export performance of Latin American countries was much poorer than that of Asian countries, given the world

economic environment. Therefore, although the sudden change in the world economic environment may account for the outbreak of the worldwide debt crisis in 1982, the prolonged debt crisis in Latin American countries and the Philippines after 1982, is the result of the legacy of the import substitution-oriented-development strategy combined with the heavy debt owed to commercial banks aggravated by high real interest rates and weak commodity prices. These interactions of the world twin debts clearly demonstrate the complexity of the issues and difficulties of resolving the twin debt problems. Out of the complex of issues, the next section will pick up two: What adjustment mechanisms have actually worked under the international debt management pursued since 1982? Which goals of international debt management have been so far met? The second issue will lead us to an evaluation of outcomes.

2. Main features of the adjustment problem of developing debtor countries in 1982—87

(a) Are the goals of international debt management met?

After having dealt with a liquidity problem and international banking crisis triggered by the Mexican inability to meet debt service obligations in August 1982, international debt management has been intended to meet three goals. One goal is to permit a politically acceptable rate of economic growth in debtor countries. However, it is to be noted that their economic growth is conditioned largely by imports of raw materials, industrial intermediate and capital goods. A second goal is to maintain sufficient new net lending to the debtor countries in order to provide incentives for continued compliance with debt service obligations. A third goal is gradually to improve the financial positions of the creditor banks. These goals tend to conflict with each other. The debtor countries naturally seek smaller debt service payments and a greater net capital inflow in order to permit faster economic growth rates. However, the creditor banks want larger annual debt service receipts and smaller exposure to the problem debtor countries which would satisfy the interests of their stock holders. The issue of how to reconcile these conflicting goals has been the essence of the problem of international debt management of 1983—87 (Dornbusch 1987).

What outcomes have resulted from the international debt management pursued hitherto?

As shown in Table 2, in the 1970s growth performance was generally good at above 5 percent annual rate for all sub-groups of capital importing developing countries, including those countries that were subsequently to encounter debt-servicing problems. This generally satisfactory picture changed fundamentally in the 1980s.

In 1981—82 a sharp slowdown from the order of 5 percent to 2.2 percent was registered by capital importing developing countries. If borrowers are divided into those that eventually had to reschedule debt (labelled countries with debt-servicing problems in Table 2, or, in short, the problem debtor countries) and those that were able to avoid such problems, the former group suffered zero growth, in sharp contrast to a 4.7 percent annual growth rate of the latter group. Even more importantly, the revival of growth in the five years (1983—87) since the onset of the debt crisis has not been widespread. While other groups restored economic growth to the satisfactory rates of the 1970s, the problem fifteen heavily indebted countries or Latin American debtor countries have been able to grow only at approximately 2 percent per annum in 1983—87 (Table 2). In this context it should be noted that investment ratio to GNP declined most sharply (5 percentage points) in the problem debtor and fifteen heavily indebted countries from 1970s to 1983—87. In contrast, countries *without* debt-servicing problems more or less maintained high investment ratios of 26—27 percent, as shown in Table 3.

Therefore, the first goal of international debt management has not been achieved.

How about a second goal of maintaining sufficient new and net lending? The problem debtor countries registered a current account *deficit* of around $16 billion per annum but also a trade account *surplus* of around $23 billion per year in 1983—87. The difference between the trade account surplus and the current account deficit is essentially interest payments of about $55 billion per year as shown in Table 4. Therefore, such difference means that the problem debtor countries have paid an enormous amount of interest through generating surpluses on trade account and on non-interest current account, i.e. transferring net real resources (exporting more and importing less as shown in Table 4). This net resource transfer stands in sharp contrast to the trade account deficit during the preceding period. But such surpluses remained short of meeting interest obligations. As a result, the debtor countries required continued net capital foreign borrowing in 1983—87.

Did this mean that the banks continued to extend new loans, voluntary or involuntary, so that their financial position did not improve, jeopardizing achievement of a third goal of international debt management?

The global distribution of bank claims in the problem debtor countries indicates that out of about $200 billion of total bank debt outstanding of Latin America, U.S. banks owed about $75 billion, UK banks $40 billion, and Japanese banks $30 billion and that the remaining $55 billion or so is divided among German, French, Canadian, Swiss and other banks (Sachs and Huizinga 1987). The banks have been allowed to keep almost all of their developing countries exposure on the books at face value. They have been able to count as current income all the interest payments they receive on

the loans, even when the interest payments are made possible only by new "involuntary" loans to the debtor countries. In fact, the debt problem did not exert a serious adverse effect on current earnings of the banks so far as the bookkeeping is concerned. Only in 1987 did U.S. banks report *negative* net income as some of the large debtors, expecially Brazil, suspended interest payments and as the banks made significant additions to loan loss reserves. Through these debt management arrangements since the onset of the debt crisis in 1982, the banks have been given time to reduce their exposure in the problem debtor countries as a percentage of the book value of primary capital, as shown in Table 5.

How could the extension of new involuntary loans be compatible with the declines in U.S. banks' exposure? First, net capital borrowings by the problem debtor countries in the 1980s have been no more in the form of voluntary bank lending, unlike the case of the 1970s. Most of any increases in such net capital borrowings were from non-banks such as international financial organizations and governments (see Table 4 for sources of net external borrowing). Second, the widely publicized concerted lending agreements in recent years have been "new money" exclusively to the public sector in the debtor countries, which increased by 53 percent in 1982—86. At the same time, however, the banks have been withdrawing loans from the private sector which declined by 48 percent during the same period (Table 4, last row). Though sovereign loans, i.e. those to foreign public sector borrowers, account for about two-thirds of U.S. bank lendings to developing countries, total U.S. bank loans actually registered an absolute decline due to the substantial withdrawal from the private sector in the problem debtor countries.

(b) An evaluation of the mechanisms involved in the present international debt management

A simple illustration is useful to understand how the overall adjustment mechanisms actually worked over the past several years. Suppose that a country owes $10 billion of debt and that principal repayments are always rescheduled (as actually happened through difficult negotiations). Under the present debt-management arrangements, the country would pay the full $1 billion of interest as interest of the contracted value of $10 billion debt if the market interest rate is 10 percent. However, the country's capacity to make a net resource transfer, which is constrained essentially by maximum allowable reduction of imports (and hence economic growth) and prospects for exports given the present policies, often falls short of such interest payment obligations. If the country's capacity of resource transfer is $0.6 billion, it will have to obtain a concerted new loan of $0.4 billion to pay $1 billion interest. Each year the country would get a new concerted loan and hence the debt would

continuously grow from the original $10 billion to $10.4 billion in the second year and to $10.84 billion in the third year and so on. From the viewpoint of U.S. banks, net income flow would continue to be $1 billion in the first year and more in subsequent years. As a result, debt/GNP ratios of the problem debtor countries would grow since the GNP growth rate would tend to be slower than debt accumulation. Such slower economic growth was caused by declines in imports of necessary intermediate — and capital — goods which were in turn enforced to generate the trade account surpluses. If the banks could raise primary capital when concerted new loans simply maintained the level of loan outstandings largely unchanged, the capital/debt ratio could improve in due course (Table 5). This is the basic mechanism through which all measures of creditworthiness of the problem debtor country's have worsened in 1983—87 as shown in Table 6, while the U.S. banks exposure ratios have declined.

How should we *evaluate* such mechanisms?

The most important contribution of the mechanisms is that the international banking crisis has been avoided. Debtor countries have not repudiated nor have creditor banks or central banks had to deal with large-scale debt defaults. In addition, as noted above, balance sheets of creditor banks have been strengthened by additions to capital and loss reserves and by reductions in foreign exposure to the problem debtor countries.

During the period 1982—87, the world macroeconomic situation also improved: (1) nominal dollar interest rates declined, although real interest rates (adjusted for world commodity prices) did not fall but actually rose in 1985—86, (2) the U.S. dollar weakened after 1985 and (3) industrial countries maintained economic growth at more than 3 percent per annum during 1983—87 after less than 1 percent annual growth during 1980—82. By taking advantage of the favourable world macroeconomic situation, both Republic of Korea, which had once been involved in the international financial crisis of 1982 due to its heavy external debt, and other south-east Asian countries succeeded in maintaining or even enhancing growth performance without a serious acceleration of price inflation.

The polarization of middle-income developing countries into those *with* and *without* debt servicing problems during 1983—87 highlighted the basic problem: most Latin American countries and the Philippines which had engaged in import-substitution policies as a development strategy confronted much more difficult structural adjustments and reforms than those engaged in more realistic import-substitution and export-promotion polices (Yoshitomi 1984 and Sachs 1985).

The crucial factor is how effectively and efficiently external borrowing was utilized so as to generate export earnings sufficient enough to meet interest obligations. This effective and efficient use, in turn, depends critically on trade policies and exchange rate management. In most of Latin American countries (especially the

Southern Cone) and the Philippines, trade and exchange rate policies have discriminated against export sectors. In Asia, protectionist policy measures for import-competing sectors went hand in hand with export promoting policies. The essential difference in a development strategy between Latin America and Asia has been not in protective trade policies for import-competing industries but in the anti-export bias of protectionism in the Southern Cone, in the sense that exportable sectors have been discriminated against in favour of both importable and non-tradeable sectors. In Asia, while protecting import-competing industries, export promotion policies have allowed greater resources to be allocated to exportable sectors in accordance with foreseeable changes in dynamic comparative advantages. Thus, the Latin American external debt has become burdensome largely because of insufficient exports available to service its debt. Short maturities of external debt and variable interest rates aggravated this fundamental weakness. Therefore, when the creditor banks wanted to withdraw their loans, almost the only way that Latin American countries could maintain debt servicing was through a recession and a sharp reduction in imports combined with debt reschedulings. As discussed in this section, the continued prolonged crisis in 1983—87 is characterized not by outright repudiations or defaults but by the adjustment mechanism in which the problem debtors turned their primary current account into surpluses which, together with involuntary lending by banks, enabled the debtors to pay large interest, but at the enormous cost of cutting down imports and domestic investment.

Therefore, six years after the debt crisis of 1982, the debt crisis is very much alive in Latin American countries and the Philippines. None of the major debtor countries has regained normal access to the international capital markets. At least one major debtor has been in trouble each year.

The key question for the new phase is how the adjustment mechanisms involved in a newly designed international debt management strategy could provide strong incentives for the problem debtor countries to commit themselves to their own structural reforms whereby productive investment and export capabilities can be enlarged so as to restore access to international financial markets. Such an incentive could be strengthened by introducing a mechanism in which easing the interest payments burden by reflecting the discount in the secondary market of bank debt should be strongly linked to structural reforms: benefits of structural reforms in terms of lower consumption, stronger investment and enlarged export capacity should not be siphoned up into larger interest payment obligations. This specific policy issues will be discussed further in the concluding section.

3. What has been and will be the impact of rectifying the imbalances of the U.S. and Japan?

How have international payments imbalances been corrected by the U.S. and Japan? The adjustment process of the developing countries' debt problem must be greatly influenced by the unwinding of imbalances between advanced countries. Our examination of the actual impact of the correction of imbalances in 1985—87 should also throw light on the issue of what will be the impact of further adjustments of imbalances by advanced countries in the next several years.

Dramatic adjustments have already been taking place in the international trade of advanced economies. The *volume* of U.S. exports of goods increased by 15.3 percent in 1987 and is projected to rise by 20 percent and 14.5 percent in 1988 and 1989, respectively, as shown in Table 7. In sharp contrast, the volume of Japanese exports of goods *declined* by 0.5 percent in 1986, remained nearly flat at a 0.4 percent rise in 1987 and is projected to increase by 4 percent in both 1988 and 1989. The booming U.S. exports together with stagnant Japanese exports demonstrated the effect of exchange rate changes over the past few years. Furthermore, the volume of Japanese imports of goods increased by the order of 9 percent in both 1986 and 1987 and is projected to increase by 14.5 percent and 7 percent in 1988 and 1989 respectively. In contrast, the annual rate of increase in the volume of U.S. imports remained at about 5 percent in 1987 and was expected to remain at this rate in 1988 and 1989 (Table 7).

Two questions can be raised from the above observation. One concerns the impact on the rest of the world of the change in the U.S., which stopped being a large absorber by turning its net imports (imports minus exports) from positive to negative. It has often been claimed that the rest of the world would suffer a recessionary impact once the U.S. ceased playing a locomotive role in the world economy. Did such projection turn out to be justified? The other question is why and how the current account deficit of the U.S. and surplus of Japan improved so slowly despite the aforementioned dramatic and desirable change in the volume of international trade.

Let us briefly discuss these issues in turn. Between 1987 and 1989, almost half of the increase in the volume of OECD exports is projected to accrue to the United States. This is the striking feature of the improvement of the U.S. trade account in volume terms. On the other side of the coin, nearly every OECD country is projected to lose market share, and by 1989 the U.S. share of OECD exports (in volume terms) is expected to be at a 25-year high!

The potentially deflationary impact of this external adjustment by the U.S. must be reflected in declines in net exports (exports minus imports) of the rest of the world in volume terms. Actually, Japan's

real net exports declined by 0.9 percent of GNP in 1986 and 1987, and are projected further to decline by 1 1/4 percent and 3/4 percent of GNP in 1988 and 1989. Likewise, total OECD Europe's real net exports declined by 1.4 percent and 0.9 percent of GNP in 1986 and 1987, respectively (Table 7), Taiwan's net exports in volume terms has been substantially declining since 1986 and Korea's net exports are expected to decline from 1988.

Despite this drastic turnaround in international trade in volume terms, there have been no particular signs of a worldwide slowing down of economic performance. The annual growth rate of total OECD real GNP has indeed been remarkably well maintained. Although a slowdown is expected in 1989, this is not attributable to a potentially adverse impact of the U.S. external adjustment in volume terms. Moreover, world trade volume is projected to grow by 6—7 percent per annum in 1988—89, as compared with 5 percent per annum in 1986—87.

This leads to the second question of why the current account deficit of the U.S. *in nominal terms* has been too slow to improve despite the aforementioned drastic change in trade flows (in volume terms) between the U.S. and the rest of the world.

The basic reasons why the U.S. overall nominal current account has improved so slowly, despite the export boom, are rather simple. First, a weaker dollar has led to the deterioration of the terms of trade of the U.S., i.e. higher import prices than export prices, aggravating the nominal value of imports. For example, a 6 percent rise in import prices will increase the value of imports by $25 billion in 1988. Second, net investment income paid abroad has been deteriorating on average by $10 billion per year. After allowing for only these two factors, there is virtually no room for the volume of U.S. imports to increase, if the current account deficit is to be trimmed even by as little as $15 billion a year. Yet in 1987, the volume of U.S. imports increased by 7 percent. Policy implications can be drawn from this: to reduce the external deficit, the *total* volume of imports has to be curtailed. However, the volume of imports of capital goods into the U.S. has been strong, reflecting stronger business investment. This is because about one-third of such business demand for machinery and instruments are now met by foreign suppliers, as compared with about 15 percent in the early 1980's. This suggests that U.S. imports of consumer goods should be cut sharply.

It is important to note that so long as the total volume of U.S. imports increases, the current account surplus of Japan will not rapidly decline despite its rapid growth of imports, because Japanese exports, particularly those of capital goods, will remain quite strong. In other words, the Japanese external surplus depends strongly on the U.S. external deficit, but not the other way around, because of the sheer size of the U.S. economy, its high income elasticity of imports and of the large share (40 percent) of Japan's exports to

the U.S. in its total exports. The persistent surplus of Japan is related closely with persistently strong U.S. imports. This relationship applies more or less to other surplus countries, as suggested in the pervasive deterioration of the U.S. external trade in the first half of the 1980s. In addition, the increase in Japanese net investment income makes it even more difficult for Japan to reduce its current account surplus.

The world economy confronts a difficult choice. On the one hand, as demonstrated by the stock market crash in October 1987, the slow adjustment of the U.S. external deficit led to a triple decline of three assets in three portfolio markets: a fall of the dollar triggered by a larger-than-expected external deficit led, via an aggravation of inflationary expectations, to a decline of bond prices (i.e. higher long-term interest rates) and hence to a decline of stock prices. Entering 1988, the U.S. trade deficit, though not necessarily the current account deficit, began to improve, resulting in some stabilization of the dollar. At the same time, however, the possibility of overheating of the U.S. economy and hence an acceleration of actual and expected inflation has become greater, actual rates of unemployment have steadily declined to the natural rate "zone" of unemployment of around 5.5 percent. If this acceleration of inflation cannot be kept under control, the failure of inflation control will lead to a free fall of the dollar, resulting in a disastrous world-wide financial recession through tight monetary policy in the U.S.

This would be the worst scenario that could happen in the course of the adjustment process of the present international payments imbalances.

On the other hand, however, it is often argued that reducing U.S. domestic demand in order to improve its external account and to dampen its inflationary expectations would be deflationary. Note that the U.S. economy would not suffer a recession in terms of GNP, thanks to the aforementioned export boom and strong business investment. What is needed for the U.S. is now a consumption recession, which would result from a substantial cut of the structural fiscal deficit through freezing nominal government expediture, particularly defence, stretching out inflation-indexation of social security benefits, a rise in gasoline tax (a 25 cent per gallon increase would raise tax revenue by $25 billion!) and an introduction of a nation-wide consumption tax. At the same time, monetary policy has to be "inflation-preventive" lest the monetary authorities should be forced to introduce much tighter measures later on. Such a consumption recession, i.e., dampening domestic demand except business investment, would be deflationary on the rest of the world, although it would be accompanied by a lowering of long-term interest rates in the U.S. This is the other scenario that we should choose if the worst scenario is to be avoided.

What would be the order of magnitude of the impact of such an adjustment on the world economy? Some results of simulations performed by using the EPA World Economic Model are reported

in Table 8. Suppose that the U.S. fiscal deficit would decline by $15 billion, compared with the present level of $150 billion, every year from 1988 to 1992 through continued expenditure reduction. The U.S. current account would improve by $46 billion in 1992 from the baseline for the same year. Simply assuming that the 1992 baseline of the U.S. current account deficit remains unchanged from the abovequoted projected deficit of $132 billion for 1989, such fiscal action would reduce the U.S. external deficit down to $86 billion, or about 1.3 percent of GNP in 1992. At the same time, Japan's current account surplus would decline by $29 billion in the same year from the baseline and reach a level of $51 billion or 1.5 percent of GNP in 1992, if the baseline surplus is again assumed to remain unchanged from the projected surplus of $80 billion. This simulation clearly demonstrates that, given the present real exchange rate relationships, the U.S. fiscal deficit reduction of $15 billion per year would lead us to much more sustainable international imbalances of the U.S. and Japan. However, such fiscal contraction would reduce the growth rate of world trade by 0.5 percentage point from the assumed baseline of, say 5—6 percent. Both U.S. and Japan would suffer 0.3 and 0.5 percentage point slowing down of real GNP respectively. At the same time, U.S. long-term interest rates would decline by 3.8 percentage points, given that the nominal money supply remained unchanged under this fiscal contraction.

This is not an easy choice, but only this choice and a resultant U.S. consumption recession can provide us with the long-run sustainable solution to the present imbalances, lower dollar interest rates and the avoidance of serious financial turmoil.

The solution to the developing country debt overhang can also be facilitated by this policy choice, for three reasons. First, the long-run sustainable solution to the U.S. external deficit through improving its domestic S-I balance will free up the bulk of foreign savings which the richest key-currency country now needs to absorb to finance its own deficits. Second, the lowering of dollar interest rates will substantially ease the debt service burden of the problem debtor countries. The exponential increase in the debt service/export ratio can be avoided partly by lowering dollar interest rates below the rate of increase in the value of exports of the debtor countries. Third, the worst financial scenario of a sharp free fall of the dollar and very tight monetary policy in the U.S. would throw the world economy into a deep financial recession, aggravating the developing country debt overhang. This would be far worse than a case where growth recession of the world economy might be induced by the above-defined U.S. consumption recession.

It is important to recognize a few basic differences in the nature of problems between the U.S. external deficit and the debt problem of middle-income developing countries. First, the present problems confronting the U.S. economy do not include an inability to meet debt service obligations. It is sometimes argued that once the net

external liabilities of the U.S. reaches $1 trillion in the early 1990s which is equivalent to the present size of total external debt of capital importing developing countries, foreign investors will suddenly withdraw their funds from U.S. markets by anticipating debt servicing difficulties, and that the resultant collapse of the dollar will trigger a world-wide financial depression. However, $1 trillion debt will be about 15 percent of U.S. GNP of the early 1990s and net investment income payment/GNP ratios will be still less than 1 percent of GNP partly because of the high rate of return to U.S. direct investment abroad. Second, the present U.S. external adjustment problem is characterized essentially as a classical balance of payments crisis, i.e. overspending at home at the time of full employment. Expenditure switching by a weak dollar (i.e. net export expansion and corresponding strong business investment) has to be accompanied by expenditure reduction at home. If such expenditure reduction does not follow in a timely fashion, the aforementioned triple decline of three portfolios (a dollar depreciation, bond price decline and stock market fall) would take place together with an acceleration of inflation. It is this failure of adjustment of a classical balance of payment problem that will either exponentially increase external debt/GNP ratio or trigger the free fall of the dollar. Third, the U.S. can borrow in its own currency.

Therefore, international economic cooperation to solve the U.S. external deficit requires a mechanism whereby macroeconomic discipline can be imposed on the key currency country or the GNP NO.1 economy. This mechanism should be different from one in which fiscal and monetary policy discipline can be imposed on non-key currency countries. This is a historically unprecedented challenge to G-7 international macroeconomic coordination policies as well as to the present floating exchange rate regime.

4. Conclusions

The world twin debt problems — the huge U.S. external deficit and the debt overhang of middle-income developing countries — can be resolved more effectively if they are attacked simultaneously. This is because the world twin debt problems are interrelated in their origin and in their persistence.

The U.S. current account deficit grew after 1982 partly because of substantial import cuts by the problem debtor middle-income countries, particularly in Latin America. At the same time, higher U.S. interest rates and the strong dollar in 1982—85, stemming from its expansionary fiscal policies with non-accommodating monetary policies, aggravated the debt overhang problem of developing countries. Higher dollar interest rates increased debt service obligations and the appreciation of currencies of the debtor countries pegged to the dollar weakened their export performance. The weak

export performance in 1982—87 was, however, largely the legacy of the import substitution policies without adequate export promotion measures over past decades.

At its outbreak in 1982, the debt crisis was commonly viewed as a problem of lack of liquidity. Since the liquidity crisis threatened all the debtor countries as well as the international banking system, most commercial banks shared an interest in concerted lending to protect the banking system and gain time to reduce their individual exposures to the debtor countries. The basic instruments were debt reschedulings aimed at altering the time profile of debt service. Through the debt reschedulings, the debtor countries continued to beg, obliged to pay a large amount of interest which was beyond their own capacity to pay, given their policies. The gap between interest payments and the capacity to pay had to be financed by new borrowings, largely from official international institutions rather than commercial banks. As a result, the outstanding external debt increased and major indicators of creditworthiness, such as debt/GNP ratios and debt service/export ratios, continued to deteriorate (i.e. increase). Furthermore, even the existing capacity to pay interest obligations was damaged. This is because of the curtailment of necessary imports and productive investment and also because of the elements involved in the rescheduling schemes which discourage the incentives to undertake structural reforms including overhaul of import substitution policies. An important reason why the incentives for structural reforms are discouraged is that returns to structural reforms in terms of consumption cuts, higher investment or export capacity improvement tend to benefit only the creditor banks through greater interest payments. The greater the returns to hard-to-implement structural reforms, the greater the debt service obligations through reduced new lendings rather than allowing for greater resource allocation to domestic growth of the debtor countries. Thus, net real resources have been transferred from the debtor countries to the rest of the world: the debtor countries have continuously registered surpluses on the trade account and on the primary current account since 1982. It is indeed true that since the onset of the debt crisis, concerted lending has been successful both in protecting the international banking system and in gaining time to reduce the creditor banks' exposures to the problem debtor countries.

It has, however, become increasingly clear that the debt problem involves more fundamental issues of solvency, not just a liquidity problem. Reflecting the sheer fact that the actual capacity to pay interest is lower than contractual debt service obligations, a secondary market developed for the debt of highly indebted countries. Large discounts in the secondary markets led the creditor bankers to assume that the market will value new loans at much less than book value, hence discouraging the banks from extending voluntary new loans to the problem debtor countries. By reflecting this mix of success

and failures of the debt rescheduling over the past five years as summarized above, a new strategy can and should be designed for resolving the debt overhang problem. The key to the new strategy should be to link market-oriented debt or interest relief and structural reforms, on a case by case approach.

Net real resource transfers of the problem debtor countries have also contributed to the U.S. external deficit, through the substantial reduction of imports of debtor countries. However, at bottom the U.S. external deficit is an American problem. The main reason why the current account deficit in nominal terms has been improving too slowly, despite a rapid increase in US export volume, has been the persistence of excessive import demand, supported by resilient domestic demand, in addition to an unavoidable worsening both of the terms of trade and of net investment income paid abroad. A permanent improvement of the I-S balances can be made possible by various fiscal consolidation measures. Freezing of government expenditure in nominal terms, particulary defence, a stretching out of inflation indexation in public pension benefits, an increase in gasoline tax, an introduction of consumption tax, and a substantial reduction of tax exemption interest paid on mortgage and consumer loans are just a few examples of such measures.

This permanent solution to the U.S. external deficit may produce a slow-down of the growth rate of the world economy. This is, however, the only choice to make if we really want to avoid the worst financial depression, which would be triggered by a free fall of the dollar, unless the reduction of the U.S. current account deficit has to be speeded up. Furthermore, the adverse impact on debtor countries of such a growth recession of the world economy will be greatly mitigated by a lowering of dollar interest rates and of inflationary expectations. Most importantly, the reduction of the U.S. current account deficit will free up the bulk of foreign savings hitherto absorbed into U.S. financial markets. Combined with a newly designed international debt management, the freed-up foreign savings should flow into the debtor countries so as to facilitate the growth-oriented adjustment and correction of the debt overhang of middle-income developing countries.

Japan's role should be to facilitate the adjustment process of the world's twin debts problems by mitigating the various difficulties identified in this paper. In particular, Japan can and should play a crucial role in the following several areas. First, Japan should design a new international debt management scheme in which a link should be established between market-oriented debt or interest relief and enhancement of the incentives of the debtor countries to commit themselves to structural reforms on a case by case approach. Depending on the scheme, if needed, Japan should be prepared to provide necessary financial contributions.

Second, Japan should develop a new mechanism whereby macro-economic discipline can be imposed on the key currency country.

This is because the unsustainable monetary and fiscal policies in the U.S., i.e. monetary expansion in the 1970s and fiscal expansion in the 1980s, have been the essential source of large swings of exchange rates over the medium-run under the present floating regime. As the largest creditor country, Japan might be in a position to exercise its power to impose such discipline on the U.S., as a large debtor country. In the long-run, a new international monetary system should be designed and developed in order to avoid unduly large swings of exchange rates over the medium-run which distort international resource allocation and strengthen protectionism in the countries with overvalued currencies.

Third, Japan should be a large and stable absorber for foreign suppliers of goods and services. This function can be well served through keeping its own macroeconomic house in order and undertaking its own structural reforms. Macroeconomic policies themselves should be sustainable over the medium-run and should not be unduly fine-tuned in order to avoid stop-and-go policy outcomes. Japan's own structural reforms should be implemented, particularly through deregulation and liberalization of inefficient non-manufacturing sectors in Japan ranging from agriculture to distribution, construction, transportation, housing and insurance and so on. Such structural reforms will improve productivity and therefore reduce levels of prices and charges in the non-manufacturing sector and contribute to enhancing the domestic purchasing power of the Japanese yen at home. This must also lead to a larger absorption of both domestic and foreign demand.

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Table 1.

Pervasive deterioration of U.S. manufactured trade balance across goods and countries. 1981—86

	Percent of total (%)				Change in trade balance between 1981 and 1986 (billions of dollars)	
	Exports		Imports		Actual	Proportional[1]
Category	**1981**	**1986**	**1981**	**1986**		
Capital goods	69.6	67.8	33.5	32.5	— 43.2	— 43.6
Automotive products	15.6	19.0	28.7	33.4	— 45.8	— 38.4
Consumer goods	14.8	13.2	37.8	34.1	— 44.0	— 50.8
Region						
Canada	20.2	24.0	20.2	17.2	— 14.4	— 30.3
Japan	6.1	10.0	25.3	27.4	— 38.4	— 38.4
Europe	23.2	24.0	22.4	22.4	— 32.1	— 33.5
Other developed countries	8.8	8.3	5.6	5.3	— 8.3	— 8.3
LDCs	40.5	31.6	25.0	25.9	— 54.9	— 36.9
Asian NICs	5.9	7.7	13.6	15.5	— 23.3	— 20.5
Centrally planned	1.2	2.1	1.5	1.8	— 1.5	— 2.2
Total (billions of dollars)	166.8	169.8	156.4	308.9	—149.6	—149.6

Source: R.Z. Lawrence and R.E. Litan "The Protectionist Prescription: Errors in Diagnosis and Cure", Brookings Papers on Economic Activity, I: 1987
Note: [1]) The trade balance that would have been in each category or region if the 1981 proportions of total imports and exports had been maintained.

Table 2.

Growth performance of capital importing developing countries, 1973—87

	Shares of subgroups 1984—86 (all developing countries = 100)				Average annual growth rates of real GDP (%)			
	GDP	Exports	Debt	Number of countries	1973 —77	1978 —80	1981 —82	1983 —87
Capital importing developing countries	87	82	94	126	5.4	5.0	2.2	3.9
Countries *with* debt servicing problems[1])	43	32	58	65	5.2	4.4	—0.1	2.1
Countries *without* debt servicing problems[2])	44	50	36	61	5.7	5.6	4.7	5.9
Fifteen heavily indebted countries[3])	32	21	42	15	5.7	5.0	—0.2	1.8

Source: IMF, World Economic Outlook, April 1988 p.74 and p.104
Notes: [1]) defined as those countries which incurred external payments arreas during 1985 or rescheduled their debt during the period from end—1983 to end—1986.
[2]) All other capital importing developing countries than defined as footnote 1.
[3]) Argentina, Bolivia, Brazil, Chile, Columbia, Côte d'Ivoire, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Venezuela and Yugoslavia.

Table 3.

Investment, consumption, and saving rates in the problem debtor countries
(In percentage of GDP, %)

	1973—77	1978—80	1981—82	1983—87
Countries *with* debt-servicing problems				
Investment	26.5	26.3	24.1	19.2
Consumption	72.6	74.9	77.4	77.3
Saving	24.2	22.7	18.6	17.7
Countries *without* debt-servicing problems				
Investment	27.3	28.4	26.9	26.4
Consumption	75.0	74.4	75.2	73.2
Saving	26.1	26.5	24.4	24.6

Source: IMF, World Economic Outlook, April 1988. p.77

Table 4.

Countries with recent debt-servicing problems: current account transactions and external financing

	1980	81	82	83	84	85	86	87	88	89
									(Projections)	
Export volume (annual average, %)	3.4	— 4.1	— 4.4	5.7	8.3	1.8	—	2.5	5.0	3.6
Import volume (,,)	3.8	3.2	—14.2	—13.8	3.0	— 1.7	— 5.5	— 0.5	4.4	3.8
Terms of trade (percentage change)	5.4	— 2.4	— 3.4	— 2.4	2.2	— 2.4	—16.1	0.6	— 1.5	0.2
Trade balance (in billion of US$)	— 3.6	—23.6	— 7.3	21.8	34.8	34.8	15.3	22.5	22.6	24.2
Investment income, net (in billion of US$)	—24.4	—36.2	—47.5	—45.2	—48.7	—47.8	—44.2	—43.7	—46.7	—47.6
Interest payments (in billion of US$)	—37.5	—52.3	—60.7	—55.2	—60.5	—58.9	—53.8	—51.9	—55.0	—56.3
Non-interest current account (in billion of US$)	— 4.8	—20.2	— 6.0	22.8	50.0	52.4	31.6	36.8	38.5	39.0
External financing (in billions of US$)										
Non-debt-creating flows, net	9.1	11.2	11.9	9.0	9.4	10.8	9.9	11.2	11.8	13.3
Net external borrowing	60.4	81.6	66.1	38.1	24.9	10.6	14.9	16.3	20.2	22.7
Long term borrowing from official creditors	15.0	18.9	17.8	20.0	18.1	16.5	21.0	22.9	19.9	14.7
Reserve-related liabilities	2.3	9.1	23.7	18.3	8.6	1.7	10.3	— 3.2	— 1.5	7.1
Other borrowing	43.2	53.5	24.6	— 0.3	— 1.7	— 7.6	—16.4	— 3.4	1.7	0.8

Table 5.

U.S.banks' exposure to developing countries, 1982—86
(As percentage of banks capital, %)

	End—1982	End—1986
	All U.S.banks	
All developing countries	186.5	94.8
Latin America	118.8	68.0
	Nine major banks	
All developing countries	287.7	153.9
Latin America	176.5	110.2
	All other banks	
All developing countries	116.0	55.0
Latin America	78.6	39.7
Addendum	**Total bank capital** (in billions of US$)	
All U.S.banks	70.6	116.1
Nine major banks	29.0	46.7
All other banks	41.6	69.4
	Bank primary capital as % of total assets	
Ten major banks	4.8	7.1

Source: J. Sachs and H. Huizinga (1987)

Table 6.

Indicators of creditworthiness of the problem debtor developing countries

	1980	**83**	**86**	**87**	**88**	**89**
					(Projections)	
Total debt (in billion of US$)	385	545	626	670	693	714
Long-term						
To official creditors	94	144	211	244	264	279
Guaranteed debt to banks	115	188	242	255	261	264
Unguaranteed	103	132	119	112	107	107
Total debt/GDP ratios	33.7	46.4	49.2	51.2	49.9	48.0
Total debt/export ratios	152	240	305	299	290	278
Debt service/export ratios	26.6	38.8	35.0	29.0	31.8	29.1
Interest service/export ratios	12.9	23.7	21.8	17.0	20.8	18.6

Source: IMF, World Economic Outlook, April 1988 Appendix Tables

Table 7.

External adjustments of U.S., Japan and Europe, 1986—89

	1986	1987	1988	1989
	(Actuals)		(Projections)	
Real GNP				
U.S.	2.9	2.9	2.75	2.5
Japan	2.4	4.2	4.25	3.75
OECD Europe	2.7	2.8	2.5	2
Real domestic demand				
U.S.	3.9	2.5	2	1.75
Japan	4.0	5.1	5.5	4.25
OECD Europe	4.1	3.7	3.25	2.25
Net external demand				
U.S.	—1.0	0.4	0.75	0.75
Japan	—1.6	—0.9	—1.25	—0.5
OECD Europe	—1.4	—0.9	—1	—0.25
Export volume (customs basis)				
U.S.	5.9	15.3	20	14.5
Japan	—0.5	0.4	4	4
Import volume (customs basis)				
U.S.	13.5	5.6	5.75	5
Japan	9.7	9.1	14.5	7
World trade	5.0	5.2	6.75	6
Current account balances ($ billion)				
U.S.	—141	—161	—150	—132
Japan	86	87	85	80
Germany	38	44	47	42
Current balances as % of GNP				
U.S.	—3.3	—3.6	—3.1	—2.6
Japan	4.4	3.6	2.9	2.6
Germany	4.2	3.9	3.8	3.3

Source: OECD, Economic Outlook, June 1988

Table 8.

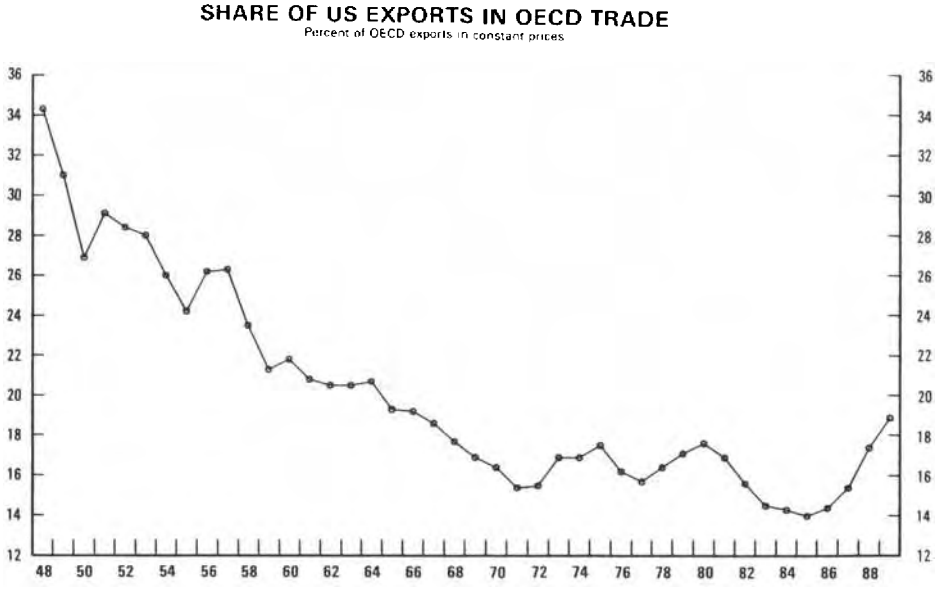
Impact of U.S. fiscal deficit reduction[1]) on the world economy: some results of EPA World Model simulations

	Annual average rates of change for 1988—92 (%)	
	U.S.	Japan
Export volume	—0.9	—3.9
Import volume	—2.9	—1.0
Real GNP	—0.3	—0.5
Real domestic demand	—0.5	—0.1
Interest rates (percentage points)	—3,8	—1.4
	Absolute deviation from the baseline in 1992 ($ billion)	
Trade balance	+27	— 7
Current balance	+46	—29

[1]) $15 billion reduction of U.S. government deficit every year from 1988 to 1992 through U.S. government expenditure cut of $ 23 billion every year.

Source: EPA, "External Balance Effects of Exchange Rate Effects and Macroeconomic Policies." March 1988.

Chart



Source: OECD, Economic Outlook, June 1988

THE ROOTS OF THE CURRENT CRISIS

Celso Furtado

As de Tocqueville predicted more than 100 years ago, world politics came to be dominated in our age by two powers, chiefly because of the ideological confrontation between East and West and the technological advances that have altered the nature of war between great powers. Such a war could never be seen as a "continuation of politics by other means" — which was how Clausewitz described armed conflict.

In fact, nobody is unaware that the shifts caused by the Second World War led to a considerable concentration of political power, as the United States came to play the dominant role in the vast world of the capitalist nations.

A bilateral political confrontation arose on a planetary scale, at the same time in which the financing of technological progress — the spearhead of this confrontation — became, for the most part, a role assumed by the leading political powers. At the level of the ordering and regulating of economic activities in the capitalist world, the scope of these fundamental changes has not yet been fully understood.

It is enough to consider that the institutions conceived after the war for the purpose of regulating international relations — the International Monetary Fund and the International Bank for Reconstruction and Development — were founded upon the principle of the efficacy of internal regulation and, therefore, presupposed the existence of self-regulated national economies. The internal regulating of each national system was to take precedence over external relations, the imbalances in the latter being considered to be the result of short-term dislocations to be corrected with the help of multilateral organizations. Some degree of international co-operation would be sufficient to avoid the imbalances that had characterized the world in the period immediately prior to the war. It was important for the national economies to resist external recessionary pressures through the use of internal expansionary measures or the recessionary forces would tend to prevail.

What occurred in the postwar period was an increasing integration of national productive systems and, subsequently, of financial and monetary systems. The progressive opening of national economies to the international community — the share of foreign trade in the industrialized capitalist economies doubled or even tripled — introduced qualitative changes into international trade and into the role played by this trade in the dynamics of the national economies.

The traditional trading of manufactured goods for primary products or goods from different climates had been jeopardized by technical progress that produced an increasing flow of synthetic products. Supported by economies of scale of production and the diversification of supply in the areas where product technology most rapidly advanced, the new vogue in international trade took the form of exchanging manufactured goods for other manufactured goods. This type of trade facilitated the dissemination of technical innovations, since it was possible to introduce new products simultaneously in a variety of national markets. In this way, technological progress became a privileged instrument of penetration into the international economic sphere, at the same time in which export growth became the primary factor in the strengthening of national economies.

One should also bear in mind the privileged position occupied by the U.S. immediately after the war, making easy for that country to create financing facilities for the market economies that had been devastated by the war, while encouraging the dismantling of the old colonial structures. Everything was done to reduce tariff barriers and facilitate the installation of American companies abroad.

The rapid progress of the technologies of information and telecommunications provided the big companies with enhanced spatial scope, increasing the manoeuvering room they had to cope with the pressures of unions in their country of origin. This was to be the starting point for the structural transformations which seriously compromised the economic self-regulating capacity of the U.S.

In Brazil, the process of the opening of the economy in the postwar period took the form of corporate transnationalization, in which the transactions between the parent companies and their respective subsidiaries abroad accounted for a growing share of the external economic relations. Since the subsidiaries normally utilize already amortized technology, their production costs are in general lower. This explains the development of a growing flow of exports towards the American market from the subsidiaries.

In their traditional form, capital exports tended to strengthen the exporting country's balance of payments by generating inflows of interest and dividends. It is well known that, at the end of the 1920s, more than a third of British imports were paid through financial earnings obtained abroad. However, the transnationalization of a productive system marked by high labor costs, such as that of the United States, could only lead to the opposite result. The profits obtained by the subsidiaries were normally reinvested locally since higher rates of return could be obtained abroad. The consequent reduction in investments in the United States had a negative impact on the absorption of new technologies, to the detriment of the competitiveness of American industries both at home and abroad. The combination of these factors is at the root of the structural

changes that generated the considerable American balance of payments deficit in the current account, in contrast to the past situation in which that country was a large scale exporter of capital.

On the financial level, the projections of these structural changes had considerable repercussions. Since American companies invested abroad while seeking funding on the United States financial market, where interest rates remained at a relatively low level for quite some time, the balance of payments position required adjustment, with the United States becoming a capital importer as well as capital exporter. This paradoxical situation was somewhat resolved by retaining abroad a share of the dollars generated by the exports of American subsidiaries towards the American market. These dollars were used to replenish the reserves of central banks or simply circulated through the international markets and became the foundation for the formation of the Eurodollar market in the early 1960s.

Transnationalization of U.S. banks

Behind the paradox to which we have referred, what was actually occurring was the transnationalization of the large American banks. By organizing their activities in a plurinational space — which made it possible for companies to combine production factors found in different countries — the industrial conglomerates sought to flee from the control of American monetary authorities, transferring their financial resources to convenient off-shore markets. The management of this mass of international liquidity, free of the control of monetary authorities, proved to be a highly profitable business and encouraged the banks to open branches abroad.

In this world of transnationalized private banks, transfers of capital from one country to another is totally unhindered by any form of regulation. The control of international liquidity is a considerable source of power, since the simple transfer of these resources between branches of the same bank located in different countries may threaten the stability of a specific currency. By mutually financing their own operations, the transnationalized banks create additional liquidity. Thus, a new decision-making process came into being in the international sphere and cut into the freedom of action of the national governments.

From the moment in which the subsidiaries of a company located abroad have access to the international financial market, the possibilities of subjecting the parent company to a national credit policy or, in other words, one based on domestic macroeconomic balances, are seriously reduced. The fact of the matter is that the parent companies can obtain resources from their subsidiaries whenever this is convenient to them.

An attentive analysis of the events of recent decades produces ample evidence of the fact that the structural transformations introduced into the American economy by the transnationalization of a large number of its companies make clear that the economy of that country can no longer be conceived of as a simple national economic system. Its problems of regulation, therefore, will take on new characteristics.

In their attempts to cope with the constraints created by the process of transnationalization, American authorities are forced to choose between a policy of high interest rates — thus worsening the employment situation — and an endless process of accumulating dollar balances abroad, thus constituting a threat to the stability of the international financial system. The traditional policy of low interest rates as the privileged instrument for stimulating the nation's economy was made unfeasible by the process of transnationalization, since it encourages a capital outflow and aggravates the balance of payments position. On the other hand, the policy of dollar devaluations aimed at stimulating exports facilitates the penetration of foreign companies and creates new pressures on the balance of payments. The foreign companies that invest in the United States prefer to place their products on the domestic market of that country. This requires that new forms of regulation be invented, which, in turn, will demand mechanisms of international cooperation that are different from those now in existence.

The traditional forms of exchange among national systems with self-regulating capacity are being replaced by other forms of relations that are emerging from within the companies themselves. However, if the reduction of the self-regulating capacity of the national systems is evident, we are still far from the concept of a global economic system, even in terms of the capitalist world. It is obvious that new structures are in an advanced stage of formation, but there is no way in which their final format can be predicted. Though companies organized on a planetary scale already exist, there is no way in which one can affirm that these are the elements of an emerging economic system of the same scope.

The economic system and the political order

Here, we come to the core of our argument. Essentially, an economic system presupposes the existence of a political order or, in other words, a power structure founded upon coercion and/or consent. At the present time, the international order expresses relations either consented to or imposed among national powers and we can only speak of economic rationality within the scope of a national economic system. The supposed wider rationality that emerges within a transnationalized company is not only one of a strictly instrumental nature, but also one that ignores costs of varying natures that are

internalized by the national systems in which they operate. In fact, the transnational company is nothing more than a cross-section in the national power structures that consequently suffer a reduction in their self-regulating capacity. Its only legitimacy is founded upon the fact that the services the company renders enhances the efficiency of the national systems within which it operates.

Let us assume that the enhanced efficiency is real or, in other words, that it can stand up to a calculation of costs based on a full accounting of all factors. In this context, one should ask: to what extent can a national economic system benefit from the transnationalization of segments of its economy, without losing its self-regulatory capacity? Looking at this from another angle — to what extent does the need to preserve self-regulatory capacity hinder a specific national economy from having access to the technologies controlled by the transnationalized companies? Here we are not dealing solely with the returns of the economies of scale — though this is relevant — but rather with recognition of the fact that an important share of modern technology is controlled by these companies.

The problem of self-regulation is particularly relevant to the so-called developing nations, since it is in these countries that the non-registered costs of foreign companies are usually quite high. The more heterogeneous a social structure, the greater will be the structural surplus of labor, while the discrepancies between the micro and macroeconomic criteria of productivity tend to become more accentuated. These discrepancies that originated in the markets themselves can only be minimized or corrected in their anti-social effects by the regulatory action of the political system.

The more that the propagation of modern technology seeks the path of transnationalization, the greater will be the difficulties faced by the developing countries in their efforts to reconcile access to this technology with the decision-making autonomy that they need to face the grave social problems that now afflict them. Many of these problems arose from the very fact that development was late in starting, thus combining an exacerbated spirit of consumption with a structural insufficiency of job creation.

However, we should not restrict ourselves only to the developing countries. The basic issue is much greater in scope, since it refers to the consequences of transnationalization both in terms of the dissemination of technology and the allocation of capital. There is no doubt that the construction of the European Economic Community was an attempt to respond to this dual challenge. The national economies of Western Europe became highly dependent on foreign trade to ensure their growth, but a large share of this trade is carried out among the countries of the same region. By internalizing a major share of international trade, the process of integration provided the companies of the region with a privileged position and limited the negative impact of transnationalization.

However, this was possible due to the fact that the EEC is the embryo of a political system and, therefore, of a government, though still limited in terms of its action. The decisions of the Community emerge from the internal law of each country and not from international law. It is in this context that a true economic system is being born — a system, obviously, highly complex.

The EEC example

The self-regulating capacity of the multinational economic system that is the EEC is still small, since the monetary and financial systems have not yet been fully integrated. However, despite this, it has already sharply restricted the decision-making autonomy of the national centers. It is this transition that is at the root of the difficulties faced by Western Europe in the context of the current economic crisis: the Community government is not yet sufficiently structured while the national governments have lost a great deal of their autonomy of action. However, there is no doubt that the construction of the EEC is the historically most significant response to the great challenges that have arisen from the postwar transformation of the international economy.

The tensions evident in the international sphere, which have been responsible for the intermittent recessions that have occurred since the mid 1970s, are rooted in the structural changes that have provoked a loss of regulatory power at the national and international levels. This process began when the United States was placed in a privileged position. However, the process of transnationalization is no less important since it made it possible for companies to protect themselves from social pressures and from the constraints of state power. The process of transnationalization was particularly successful in the fields of technology and financial resources. The companies that produce or control knowledge and manipulate monetary and financial resources are better prepared to open and consolidate transnational space. The power of these companies seeks legitimacy through the quality of the services they render, but the rules that ensure their growth are part of an international order born in the postwar period under the tutelage of the United States.

The first focal point of tension to be identified is in the shifts caused in the American economy itself. The self-regulating capacity of that country was drastically reduced by the facilities from which it benefits as a result of the privileged international position that it enjoys. Thus, there exists a basic problem of clarification of the external relations of the American economy, starting with the international creation of liquidity and the role of the dollar as reserve currency.

The second focal point originates in the loss of efficacy of the multilateral agencies that were created to correct the imbalances in

the national economic systems. By the fact that the self-regulating capacity of these national economic systems was reduced, imbalances increased drastically and denied these agencies any significant means of intervention. Consequently, the role of these agencies must be redefined in the light of the structural transformation brought about by the process of transnationalization and increasing interdependence.

If we admit that the regular functioning of an economic system presupposes the existence of a political system, we should recognize that we will only free ourselves from the current *impasse* if we move towards the construction of multinational political systems, on the lines of the EEC, and/or if we return some of the powers lost to the old national political systems. The essence of the problem is the fact that, given the differences in development levels among contemporary economies, the paths to be followed will not necessarily be the same, despite the fact that the strategic objectives are similar. An international order that gives due attention to the dissemination of the technological progress controlled by the large transnationalized companies can ensure the expansion of international trade and, by this means, instill greater dynamics in the industrialized economies. However, by reducing the decision-making autonomy of the countries marked by a delayed development process, such an order can worsen social tensions and political instability in these countries.

Evidently, the common objective is to strengthen the political sphere or, in other words, enhance the power to regulate economic activities, as the only way to place these activities at the service of satisfying legitimately recognized social needs. Efficacy in the utilization of resources and economic growth are no more than means to achieve this end. In the same way, economic integration and the construction of political systems that are wider in scope seek the same objective of ensuring stability and growth in a world in which technology and capital are increasingly controlled by transnational organizations.

As bipolar power has developed on a global scale, political confrontation has become more of a technological competition in the guise of an arms race, exacting an increasingly burdensome tribute from the two big powers. Once the world's largest creditor, the U.S. has slipped into external indebtedness, and this has damaged the dollar's role as a reserve currency, the position of the U.S. as power broker of the capitalist world is threatened. Moreover, the crash of the New York stock exchange in October 1987, coupled with the sharp decline of the dollar, was a warning that the U.S. economy can no longer depend on the international community to absorb its imbalances. To reduce pressure on the dollar, the world will tend towards a system of creation of liquidity subject to international control.

In the present situation, we can move forward through the path of multinational integration or we can take the apparently opposite

tack of strengthening national decision-making and self-regulatory power. New forms of political organization — given the example of the multi-sovereign government that is the EEC — will have to be invented to reconcile aspirations to preserve cultural identities with the requirements of modern technology and the emergence of transnational power.

New forms of international cooperation that make it possible to establish effective regulation in an increasingly interdependent world will have to be achieved on the basis of new forms of political power, capable of bringing the small and medium size national states together. However, taking this path does not mean that the countries in which internal structural modernization is a priority objective should be deprived of their self-regulatory capacity.

We live in an age in which two historical eras overlap. In one, efforts are dedicated to recovering delays that have occurred in the construction of the political system that should regulate economic activities that have already reached a planetary scale. In the other, one would seek to eliminate the anachronistic forms of social organization that condemn millions of human beings to the most abject living standards. Failure in either one of these tasks will force humanity to remain on the path of instability and uncertainty.

STRUCTURAL CHANGES IN THE WORLD ECONOMY AND NEW POLICY ISSUES IN DEVELOPING COUNTRIES

Lal Jayawardena

This paper highlights three key problems requiring resolution in the 1990s. The first is that of radically altering for the better the development experience of the developing countries during the 1980s which has been so disastrous as to elicit the description — the "lost" development decade. For the Third World as a whole, real growth which, according to the World Bank's most recent World Development Report, averaged 5.4 percent during 1973 to 1980 fell to 3.2 percent in the first half of the 1980s.

The growth of the low-income developing countries excluding the large land masses, India and China, fell to 3 percent, and in the case of low-income Africa to 0.7 percent from an already unacceptably low figure during the 1970s of 2 percent. The fall has been sharpest in the case of the debt-ridden middle-income group of developing countries — from 5.7 percent during 1973—80 to 1.6 percent during 1980—85. In per capita terms, these magnitudes translate at best into the stagnation of incomes and in many cases to actual declines. It is this dismal performance relieved only by the booming economies of the Pacific Rim which needs to be turned around in the 1990s.

The second problem is that of maintaining adequate growth in the developed economies while simultaneously correcting today's major payments imbalances between key developed countries. Clearly, the success with which this problem is tackled will crucially affect the outlook for the developing countries and the resolution of my first problem. This is particularly the case with the vast majority of developing countries which are commodity producers. While exports of the commodity-dependent countries at $ 118 billion are only one-quarter of the total exports of developing countries of $ 484 billion, the remaining three-quarters affect the fortunes of only a handful of developing countries — the four Pacific Rim tigers, together with Brazil, accounting for a little over $ 200 billion, mainly of manufactured exports, and a half a dozen or so petroleum exporters accounting for the remaining US$ 150 billion.

What most econometric studies of commodity markets have shown is that economic growth in OECD countries is one crucial

determinant of commodity prices and, therefore, of the foreign exchange earnings of the overwhelming majority both of countries and of populations of the developing world. According to one recent study, an annual growth of 2.7 percent in OECD industrial production is required "just to maintain the index of commodity prices at a stable level",[1] with slower growth being reflected in price declines. According to the UNCTAD secretariat, indeed, many of the commodities of export interest to developing countries require a much higher rate of growth just to maintain steady prices — threshold rates as high as 4.7 percent for aluminium, 4.4 percent for copper and 4.2 percent for rice. [2]

These orders of magnitude for OECD growth warranted by the needs of commodity price stability, contrast with the most optimistic medium-term growth scenarios projected for the industrial countries by the Bretton Woods institutions: — the 3 percent growth up to 1995 forecast by the World Bank in its most recent 1988 World Development Report, and the 2.9 percent to 1992 projected in the IMF's most recent World Economic Outlook. The World Bank's "base case" growth scenario is significantly worse — 2.3 percent up to 1995.

The best we can hope for on average is, therefore, rough commodity price stability at today's depressed price levels which are even lower, in real terms, than during the Great Depression of the 1930s, and represent a decline of almost 60 percent from the peak registered before the onset of the recession of the 1980s. What commodity producers obviously require are programmes of economic diversification to lessen their dependence on commodities and the task is not rendered easier by the stagnant price outlook. What is additionally needed is a combination of appropriate domestic policies and adequate external finance in support of the necessary structural adjustments. These are among the critical new policy issues that need to be tackled.

My third problem, therefore, is that of exploring what opportunities there might be in today's international situation to bring about a simultaneous assault on the two problems I have already identified. Specifically, I would like to examine how effectively the resolution of the developed country payments imbalance and growth problems can be married to finding a satisfactory solution during the 1990s for the problems of the developing countries.

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[1] D. Hartman, 'Focus on Commodities', *Focus: World Outlook,* Data Resources, Inc., No.2, 1985.

[2] *Revitalizing Development, Growth and International Trade:* UNCTAD secretariat report to UNCTAD VII, Geneva, 1987, page 109.

1. Improving development performance

I shall begin with my first problem, that of improving upon the development performance of the developing countries in the 1980s. This issue has traditionally been approached in terms of a dichotomy between the need for policy reform in the country concerned and the need for an improvement in the external environment confronting that country. This has led to a somewhat unproductive polarization of views, with the developed countries pointing to success stories such as those of the Pacific Rim in justification of the priority attaching to domestic policy reform, and developing countries blaming it all on a forbidding external environment characterized by sluggish developed country growth, falling commodity prices and stagnant aid flows. Quite obviously, action has to proceed on both fronts, and there is an opportunity in the existence of today's substantial surpluses to improve significantly the import capacities of developing countries through recycling of surpluses, provided this goes hand in hand with domestic policy reform. Before developing this argument, however, it is nevertheless helpful to obtain a sense of the constraints imposed — and even opportunities provided — by the external environment as regards sound domestic policy formulation in various groups of countries.

The success stories

Let me begin with the success stories — the handful of Pacific Rim economies namely, Republic of Korea, Taiwan, Hong Kong and Singapore. What is controversial about these countries are the factors making for success and how far they can be replicated elsewhere. While it is claimed on the one hand that their success is attributable to market forces, it is claimed on the other hand that the role of the state has been crucial.

What is worth recognizing, however, is that in these countries whatever support the state has extended to the development of entrepreneurship and to economic growth has received a massive boost in recent years from a key *external* opportunity — i.e. the expanding market represented by the U.S. current account payments deficit. This has been the principal origin of their surpluses estimated at $ 30 billion in 1987; and it is largely on the basis of the U.S. market that the aggregate exports of manufactures of the Asian NICs have been able to exceed those of France, Italy and the U.K. What is less certain is how far it was open to other developing countries to cash in on this same opportunity. Two considerations are relevant. There is the likelihood of any significant replication of the Pacific Rim model encountering protectionist obstacles. Second, the dynamo of growth in the Pacific Rim has been original equipment manufacturing (OEM) for a wide range of purchasers extending from retail

chains to multinationals as these shifted production offshore to lower cost countries. It is a nice question whether the expansion in this market would have accommodated many other suppliers.

Primary commodity exporters

The next broad category of developing countries is the overwhelming majority who are dependent on primary commodity exports. There are some 130 countries involved with a total population of almost 1.8 billion. Although the average population of a country is 13 million, the countries range in size from small Pacific islands with under 10,000 people each to India with 760 million. The most severely affected sub-group here unquestionably is Sub-Saharan Africa, where the collapse of commodity prices since 1980 and the terms of trade loss have compounded difficulties caused by prolonged drought. Over 40 countries and 400 million people are involved.[3] By 1987, the purchasing power of exports from Sub-Saharan Africa had fallen to only 62 percent of the 1980 level, involving a cumulative loss over this period of $ 96 billion, or nearly $ 14 billion a year, on average. Of this loss, more than half ($ 58 billion cumulative, $ 8 billion annual average) reflected the contraction in export volume, while the rest represented the terms of trade loss.

Either magnitude is to be contrasted with the amount of offsetting finance theoretically available from the IMF even on the most stringent basis of conditionality. Total IMF quotas for Sub-Saharan Africa amount to SDR 3.6 billion, permitting access to Fund resources of up to twice that amount or SDR 7.2 billion (equivalent to $ 11 billion) if countries were all to make four tranche drawings on the IMF. In evident recognition of the scale of this problem and the need for concessional finance outside the general resources of the IMF, the managing director of the IMF launched new initiatives, most notably the Enhanced Structural Adjustment Facility approved in 1987. This was designed to add more than SDR 8 billion ($ 11 billion) to available resources for structural adjustment in Africa and other low income countries on a basis of three year macro-economic and structural adjustment programmes to improve their balance of payments position and foster economic growth.

The annual changes in the purchasing power of exports from Sub-Saharan Africa can be seen more clearly in Fig.1. The sharp rise in the terms of trade loss in 1986 and 1987 was due partly to the fall in petroleum prices, and partly to the fall in the exchange value of the U.S. dollar (which pushed up prices of imported manufactures from Europe and Japan in terms of dollars).

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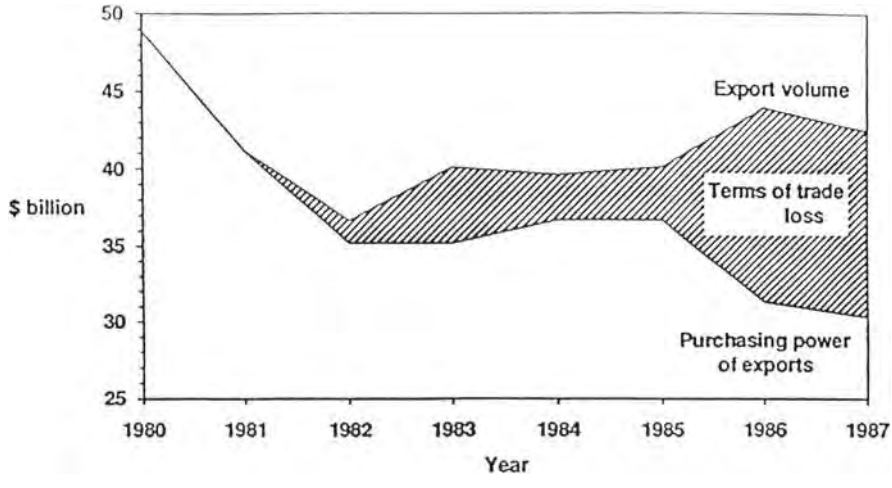
[3] UNCTAD *Handbook of Trade and Development Statistics,* 1987 Supplement, Table 6.1.

Figure 1
Exports from Sub-Saharan Africa: 1980—1987



Source: WIDER estimates based upon data in UNCTAD *Handbook of International Trade and Development Statistics* (various issues).

The decline in the purchasing power of exports was accompanied by a corresponding cut in import volume (1987 imports, for example, were some 30 percent below the 1980 level), and many countries in the region have been suffering from 'import strangulation'. For Sub-Saharan Africa as a whole, real per capita GDP declined, on average, by 3.5 percent a year from 1980 to 1986 (or from $ 575 per capita in 1980 to $ 465 in 1986, at 1980 prices). This represented a major set-back in economic welfare, including cuts in real wages, as well as in the provision of social services such as health care and education. Some rather limited data in the UNICEF study on "Adjustment with a Human Face" indicate the retrogression in child health in this region.

Also relevant to determining the influence today of external factors on domestic policy making is a comparison between the balance of payments experience of a wider group of commodity-dependent developing countries in the current recession with that in the previous (1974—75) recession. Export earnings of these countries fell off in 1975, but this fall was more than made good by an increase in capital inflows, including bank loans. Moreover, amortisation on the foreign debt was also reduced in 1975, compared with 1974. The net result was an increase in foreign exchange availability of some $ 4 billion (7 percent) in spite of the fall in export earnings. This allowed expenditure on imports to rise (by almost $ 5 billion) in 1975 — See Table 1.

Table 1

Balance of payments of commodity-exporting developing countries:[a]) 1974—75 and 1980—85

	Previous recession			Current recession		
	1974	1975	Change	1980	1985	Change
	($ billion)					
Exports	51.4	49.9	—1.5	111.7	102.1	— 9.6
Services (net)[b]) and private transfers	0.1	0.6	+0.5	16.4	19.3	+ 2.9
Long-term capital and government transfers	20.3	23.8	+3.5	44.5	46.1	+ 1.6
Total credits	71.8	74.3	+2.5	172.6	167.5	— 5.1
Debt service:						
Interest	— 4.2	— 4.7	—0.5	—17.2	—25.5	— 8.3
Amortisation	— 7.8	— 5.7	+2.1	—14.3	—21.0	— 6.7
Total debts	—12.0	—10.4	+1.6	—31.5	—46.5	—15.0
Foreign exchange availability	59.8	63.9	+4.1	141.1	121.0	—20.1
Imports	59.7	64.5	+4.8	146.9	129.2	—17.7

Source: UNCTAD *Handbook of international trade and development statistics* (various issues).
[a]) Excluding the least developed countries.
[b]) Excluding interest payments on foreign debt.

By contrast, in the 1980s, the fall in export earnings of this group of countries (almost $ 10 billion between 1980 and 1985) was compounded by a substantial increase in debt service payments (of $ 15 billion between these two years). Consequently, the amount available for purchasing imports declined, by some $ 20 billion (allowing for small increases in other credits).

Once again the comparison between the losses sustained by commodity dependent developing countries and their access to offsetting resources from the IMF is instructive. The IMF quotas of the countries covered amount to 16.4 billion SDRs or $ 22 billion. This means that access even to the equivalent of their IMF quotas on average — in effect through low conditionality first credit tranche drawings — would have barely sufficed to maintain imports at 1980 levels in 1985.

What this analysis shows is that the "import strangulation" of commodity producing countries in general is a principal factor affecting their growth outlook for the 1980s and for the future. This has implications not only for output and investment through the curtailment of import of intermediate and capital goods, but also, interestingly enough, for export performance and for this same

reason. According to a recent study of 34 developing countries, a ten percent reduction in their import volume — the average annual decline registered for these countries during 1982 to 1988 — reduced export volume by 2 percent in the short run and by more than 5 percent in the longer run after the vicious circle of import reduction leading to export reduction leading in turn to further import reduction due to lower foreign exchange availability, had been completed.[4] Nevertheless, many of these countries have attempted to bite the bullet of domestic policy reform by entering into adjustment and stabilization programmes of the conventional kind, in an attempt to ease import strangulation, by obtaining access to the additional external resources that these programmes usually permit. The difficulty, however, with the system as it is, is that the balance between adjustment and financing appears to be unfairly struck from the stand-point of the adjusting countries.

When the Bretton Woods institutions were set up, the expectation was that adequate resources would be available in support of adjustment. What has happened instead is that IMF quotas in relation to world trade, have fallen significantly since the 1940s, affecting developing countries as well — from 16 percent to 4 percent. As we have seen, additional resources resulting from even the most draconian Fund programmes are fractional in relation to terms of trade losses especially for the poorest countries in Africa and also, in lesser degree, for other commodity dependent countries. Unless, therefore, the international system finds in the 1990s ways of redressing this situation, adjustment efforts are likely to involve impossibly far-reaching and almost certainly disruptive social and political costs on the part of commodity dependent developing countries.

In the case of Sub-Saharan Africa, the acute economic and financial crisis has already called forth a significant response from the international community. Yet much more needs to be done. The report of the UN Advisory Group on Financial Flows for Africa (the Wass Report), published in 1988, after examining the situation in some detail, concluded that an additional amount of at least $ 5 billion annually, over and above what was now expected from established channels, is required for Sub-Saharan Africa, excluding Nigeria.[5] According to the report, additional financing is necessary despite previous inappropriate domestic policies to avoid "the adjustment policies being now put in place being put at risk".[6] How

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[4] Moshin Khan and Malcolm Knight, *Import Compression and Export Performance in Developing Countries,* Review of Economics and Statistics, May 1988.

[5] United Nations, *Financing Africa's Recovery,* Report and Recommendations of the Advisory Group on Financial Flows to Africa, 1988.

[6] *Ibid.* paragraph 49.

serious the situation is, is evident from the most recent IMF projection of the average debt service ratio for Sub-Saharan Africa for 1988—89 of 55 percent of export earnings, with the ratios for the sub-groups of market and official borrowers being still higher at 66 percent of export earnings.

The highly-indebted countries

A third group of developing countries consists of those traditionally classified as highly indebted. The classification straddles both commodity producers and some established NICs until their progress was arrested in the 1980s by the debt problem. The spectrum of countries in this group also shades from low income commodity dependent countries whose indebtedness is primarily to official creditors, to middle-income exporters of manufactures whose debts are primarily to commercial banks and who were the beneficiaries or victims, depending on how you look at it, of the totally unconditional recycling extravaganza of the 1970s when OPEC surpluses were mediated by the private sector. The commodity producers are largely in Africa where of 44 countries identified by the IMF only four are classified as market borrowers with others relying on official sources. The middle-income countries are primarily in Latin America.

The tragedy of this latter middle-income group of debtor countries is that their present hardships signify a major lost opportunity for cooperative international action in the 1970s, something for which abdication is not too strong a word. There was a time in the early days of the oil crisis when it looked as if the international financial institutions might well have grasped the opportunity to recycle OPEC surpluses on the basis of an appropriate regime of long-range conditionality and deliberately seek to offset the deflationary implications of the sudden shift in world savings, while simultaneously re-directing them in support of needed structural change in the developing countries. Instead the early oil facility put speedily into place by a particularly far-sighted Fund Managing Director in 1973, was equally speedily abandoned and the commercial banks left to get on with the job of borrowing short and lending long, with little thought for the morrow to come. Investments, predictably, did not bear the expected fruit, debt servicing failed, and the whole structure of the international banking system placed in jeopardy. The Mexican crisis of 1982 marked the watershed.

Then began the truly Herculean effort at *ad hoc* adjustment on a country by country basis. The grim statistical harvest of that effort

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[7] IMF Survey June 1988, page 189.

is now in and bears repetition. Countries with debt-servicing problems squeezed imports between 1983 and 1987, and ran significant trade surpluses of around $ 23 billion per year to repay banks. This meant cuts in investment by 8 percentage points, from 27 percent of GNP in the 1970s to 19 percent of GNP in 1983—1987, and of course reducing income levels. Even so, the trade surpluses were insufficient to meet interest obligations, so that countries were kept afloat by periodic packages involving the IMF which cobbled together official funds and stretched out maturities.

The principal effect of releasing budgetary resources to repay debt instead of meeting domestic needs was to erect insuperable obstacles to improved fiscal management in debtor countries which were driven to printing money to meet local expenses and risk explosive inflation. Fiscal policy proceeded on a stop go basis as financing packages fell apart almost as soon as they were put together with stipulated IMF credit ceilings being quickly exceeded. The market soon enough placed its discount both on the capacity of countries to manage their affairs in this fashion and to repay their debt in the current international environment and debt began to trade in secondary markets at fractions of their face value ranging from 20 to 50 percent.

We are now at the stage where the impossibility of official debt being repaid has been recognized. So far as commercial bank debt is concerned, the new element is that the course of debt management so far has enabled banks to restore their balance sheet positions from the critical levels of 1982. While total bank capital, of U.S. banks, for example, has increased significantly, their percentage exposure to developing countries has fallen substantially.

The stage is indeed now set for seizing once more the opportunity that was missed in the 1970s, namely that of providing financial flows under some form of multilateral stewardship if not management to developing countries under a regime of appropriate long-range conditionality. There is no lack of schemes to give effect to this concept. They all proceed on the central premise of the WIDER recycling plan[8] of passing down the discounts at which debt is trading today to debtor developing countries in exchange for long-range economic reform packages that will prove to be of an enduring character and will create a credible basis for the resumption of bank lending.

[8] WIDER Study Group Series No. 2, *Mobilizing International Surpluses for World Development, A WIDER Plan for a Japanese Initiative,* May, 1987.

WIDER's initiatives

The initial WIDER design, unveiled in Tokyo in May 1987, would be implemented through the medium of a debt reconstruction facility on which it would be open to Japan to take an initiative. For the 'Baker plan' countries this could mean a reduction in their debt service burden annually of as much as $ 10 to 12 billion, and this by enhancing their credit worthiness substantially would encourage new lending to them by the private banking system. In order to *assure* new lending, however, the view we took in the WIDER plan was that two sorts of risk would have additionally to be covered. The first was the risk of default on the principal of a loan, which we sought to cover by a zero coupon bond of equivalent value on maturity to be issued by the Japanese Government and lodged with the Japanese banking system as collateral. The second risk being run by banks was the non-payment of interest, and this we felt would be adequately looked after by a long-range package of economic reform that a country would undertake to implement as the *quid pro quo* for benefiting from the discounts at which its debt was being traded. It would also be open for more sophisticated insurance provision to be made against the risk, depending on the scheme being put in place.

Subsequent innovations in approaching the debt problem have drawn heavily on this set of ideas. The Mexican debt reconstruction of December 1987 relied upon the device of a zero coupon bond issued by the United States, not as in the WIDER plan to support new lending under a framework of long range conditionality, but simply to restructure past debt. In particular, the idea of a significant Japanese initiative has been taken up in influential Japanese quarters.[9]

The external environment constraint facing debtor countries, is somewhat different from that applying to Sub-Saharan Africa or the generality of commodity-dependent countries. No secular development like a commodity price decline linked to changed technologies and the substitution of synthetics in developed markets is involved in their case. The calamity is man-made in the sense that debtor countries have shown an extraordinary willingness to accept the import compression needed to release resources for debt servicing which are soon frustrated by unforeseen changes in the external environment. The problem here is that accompanying fiscal reform and stabilization measures cannot endure unless there is an adequate assurance extending over a relatively long period of adequate finance in support of adjustment and restructuring efforts. It is this element which requires deliberate international action, and cannot simply be left to market judgements to resolve.

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[9] See page 20, Masaru Yoshitomi, "Resolving the World Twin Debts Problem Simultaneously".

When we were putting together the WIDER recycling plan, we incorporated into our own thinking parallel reasoning on this point that had been developed by the Japan Association of Corporate Executives who were concerned about the politically and socially disruptive consequences of current adjustment policies involving excessive import compression. Their design involved both a longer range framework and donor consortia of interested countries that had a remarkable similarity to the Aid Groups that had supported over the last two decades the development efforts of Asian countries, such as India and Sri Lanka. We accordingly incorporated their thinking into our plan and I would like to cite their assessment of the situation.

> "The prolonged austerity measures consisting of fiscal deficit reduction, curbing inflation and import restrictions pursued by debtor countries have impoverished economic life of the inhabitants of such countries, (real GNP per capita in Latin America excluding Brazil, Colombia and Panama, has fallen below the 1980 level), which intensified dissatisfaction of the people and this dissatisfaction has become a *political issue.* The traditional rescheduling packages have been made through independent and case-by-case negotiations by the international organizations, governments and commercial banks. The objective of these packages has been to facilitate a *short-term adjustment.* In place of these traditional packages we propose the establishment of an "International Co-operation Committee" consisting of major governments, international organizations and commercial banks to help the debtor countries. The Committee will endorse an economic reconstruction programme to improve the industrial structure which will enable the debtor countries to *sustain economic growth and strengthen export competitiveness.* The Committee will conclude with the debtor countries a *comprehensive support agreement*... for the implementation of the above-mentioned economic reconstruction programme."(emphasis added)[10]

To summarize, we have distinguished, the success stories apart, two different groups of developing countries, those who are commodity dependent and those who have a debt problem. Obviously, some countries belong in both categories, but the external constraints affecting development in the two cases are, as mentioned, somewhat different and call for somewhat different responses. Nevertheless, there is a good deal in common at the level of evolving suitable international facilities. Both situations would seem to call

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[10] Keizai Doyukai (Japan Association of Corporate Executives), *Proposals for Solutions on International Debt Problems,* Tokyo, March 1987.

for longer-term assurances of external support and in more substantial amounts than has previously been available. Both would require looking after unforeseen contingencies that would otherwise disrupt both adjustment and development although commodity dependent countries would require very specific mechanisms. Finally, both situations would require appropriate framework for administering *long-range* conditionality under the aegis of interested donor countries. I turn now to a more detailed examination of these questions.

As mentioned, the challenge for commodity producers is to diversify their economies against the background at best of stable price expectations during the 90s and at worst of declining prices. They would need relatively long planning horizons during which the international community should seek to assure the minimum import capacities required to sustain the process of diversification. This means, in effect, providing longer term assurances for countries both as regards the export expectations underlying a development plan and longer-term assurances of aid flows additionally required to maintain relevant import capacities.

It goes without saying that appropriately designed domestic policy packages would be required to sustain internal fiscal discipline. But what is also required to prevent any restoration of discipline being blown off course by exogenous shocks, is a set of additional facilities to look after these. Many elements of this design have, indeed, been discussed within the international system for some time now. Some 20 years ago, at UNCTAD I, there was an initiative which was intended to provide an insurance to developing countries against short-falls from the expectations underlying a development plan — the so-called Scheme for Supplementary Financial Measures. The developing countries sought then to add provision for compensation against adverse movements in the terms of trade as well as corresponding assurances covering the period of a plan for aid inflows. The natural framework for this to happen, namely, Consortia or Aid groups of interested donor countries, supporting the strategy of a particular developing country were then beginning to take shape with the launching of Aid Groups for India and Sri Lanka. It is precisely this kind of framework which, we have argued, seems relevant for the debtor developing countries as well in the setting up of what we have called Policy Coordination Committees for each country, in line with the thinking of the Japanese Association of Corporate Executives.

What is of interest today is that the international system appears to be moving in precisely the direction of cushioning an adjusting economy against the kinds of random shocks that would threaten the momentum of adjustment. It had always been accepted, for example, that temporary short-falls from a five year moving average of export earnings should be financed within IMF quota limitations, and the IMF compensatory financing facility has traditionally given

effect to this. The relevant export norm could be quite different if one were thinking ahead in terms of a 5 to 10 year planning horizon as is required for bringing about resource shifts in economies with structural rigidities. It was shortfalls from such a norm which the Supplementary Financing scheme was intended to insure countries against. What is new in the IMF context is the addition of an external contingencies component to the latest revision of the IMF'S compensatory financing facility. The facility does extend an assurance to members pursuing IMF adjustment programmes to help maintain the momentum of their adjustment efforts in the face of a broad range of *unanticipated* adverse external shocks disruptive of development.

While the facility may not fully provide an underpinning for the export expectations underlying a long term development plan, it does cover unexpected adverse behaviour in the future of export receipts, of import prices and of interest rates which can be disruptive of both development and adjustment unless covered *ex ante.* What is crucial in this design is the acceptance that it would be unreasonable to expect developing countries to implement tough economic reform packages only to see their basis undermined by the sudden erosion through external shocks of the reasonable expectations about future events against which the policies had been framed. There is increasing recognition that adjustment does take time and that random shocks have to be warded off.

Sri Lanka's experience

Let me in this context cite a conclusion that has emerged from a WIDER study of Sri Lanka's recent experience with adjustment.[11] We found that the balance of payments improvement measured in constant prices brought about by a programme negotiated in 1977 had been substantially eroded by adverse movements in Sri Lanka's terms of trade. The study argues that "a genuine terms of trade facility funded through appropriate drawing rights issues, for example, is something that, in the light of the findings of the Sri Lankan country study at any rate, should be placed in the forefront of the international negotiating agenda". It is precisely the need to correct for adverse movements in import prices that appears now to be recognized in the IMF's external contingencies facility. Though the IMF quota constraints may affect the extent of coverage of their contingencies at least the way ahead has been recognized given adequate resource availabilities.

Several other initiatives would help make for a better international

[11] Lal Jayawardena, Anne Maasland, P.N. Radhakrishnan, WIDER Stabilization and Adjustment Policies and Programmes, Country Study on Sri Lanka, March 1987.

environment affecting developing countries whether they belong to the commodity dependent category or to the middle-income debtor category. The first of these relate to the administration of conditionality of a long range character on the model, as mentioned, of the Aid Groups chaired by the World Bank that had supervised for over two decades the development of Asian developing countries such as Sri Lanka. This has over the long haul had a powerful effect in keeping economic policy on a broadly sensible course in terms of avoiding gross errors, irrespective of the success or failure of *particular* arrangements with the International Monetary Fund, or the Bank. This framework has, for example, kept inflation rates relatively low, with supporting monetary and fiscal policies, prevented profligate commercial borrowing, and has encouraged possibly second-best crawling peg exchange rate adjustments under political circumstances where the more abrupt changes needed for IMF standbys were not always feasible; and it is something of this *long-range* supervision, conducted on a relatively loose rein, that we felt worth exploring for other countries. These goals are entirely in line with those elaborated by the Japan Association of Corporate Executives and quoted above, and are particularly relevant where the traditional IMF packages, whether applied in Latin America, Africa or Asia, have achieved adjustment at the cost of development.

In many cases, indeed, the conditionality involved may be no more than the economic policy-makers of a country would be willing to impose upon themselves, as a matter of self-discipline, taking political feasibilities as the limit into account, and requiring not much more than grandmotherly nudging by the Policy Co-ordination Committee. One could go so far as to say that the kind of *long-range* conditionality being looked for is, indeed, in practice *self-reliant* conditionality. Many developing countries today have the skills to work out their own approaches to structural adjustment which are a good balance between what is economically sensible and what is politically tolerable in that they are grounded in "political economy" considerations concerning which an outside international agency official may have somewhat less sensitivity.

Sri Lanka's experience with self-reliant conditionality, to cite the example I know best, is perhaps a case in point. In 1977, against a background of excessive deficit financing and incipient inflation, the bureaucracy had worked out an economic reform package that in their view was a good balance between the economically rational and politically feasible for the consideration of any new government coming into office, and it was this that was eventually sold to the Fund in exchange for a four tranche drawing. The package involved a partial cut in a food subsidy which after the cut came to 5 percent of GNP. Today the subsidy is down to .7 percent of GNP while military expenditures which in 1977 were .7 percent of GNP have risen to 5 per cent of GNP. In short, over the 10 intervening years, a subsidy burden has in effect been replaced by a military

expenditures burden.

The reason is simply that insistence by the international financial institutions in the intervening period on taking the subsidy cut further, flew in the face of considerations of political economy when a physical food ration was replaced by un-indexed food stamps against the background of an over-ambitious and hence inflationary development programme. Predictably, real wages fell with damaging nutritional consequences for the bottom 3 deciles of the population and this coincided with the emergence of acute ethnic unrest in 1983.

It was this worsening of the ethnic situation which led to military expenditures in effect replacing the food subsidy. It is possible to argue with hindsight that had the food subsidy been better targeted e.g. perhaps limited to the unemployed and indexed to inflation, its burden could have been contained and these damaging consequences avoided. In short, the moral of the Sri Lankan experience is that in sensitive areas of economic policy self-reliant conditionality is likely to be more appropriate than conditionality imposed, as it were, from outside.

Aggregate financing needs

We have so far argued for a set of new facilities and new approaches to maintaining import capacities of developing countries at levels which would facilitate growth oriented adjustment during the 1990s. What is equally relevant is to have a sense of the aggregate financing needs which these facilities are intended to underpin. It has, especially recently, been a common international practice when approaching the special problems of particular country groupings to first make soundings as to what financing magnitudes are "feasible", and to fit adjustment programmes within the straight-jacket of whatever magnitude emerges. What is perhaps more relevant and meaningful is to look ahead to the 1990s with the year 2000 as a convenient horizon to determining for the developing world as a whole an external resources gap consistent with the pursuit of minimum socially necessary growth and development goals for the Third World.

It is precisely such an exercise which is currently being set in train in WIDER in a set of 17 country studies from which it is hoped to derive a global Third World external financing requirement. Each researcher has been asked to determine on a judgemental basis the minimum socially necessary growth rate for his country, defined, for example, as the growth rate that would absorb both the backlog of unemployment and additions to the labour force up to the year 2000, and meet basic needs goals. On a quick census around the table of participants at a meeting in Helsinki this summer, minimum growth rates in the region of 6.5 percent to 7 percent emerged. This is to be contrasted with the experience for all developing countries in the period 1973—80 of real GNP growth of 5.4 percent and during

1980—87 the "lost" development decade of 3.9 percent.

Socially necessary growth rates of the order judged minimally desirable were, however, reached by the low income countries and exporters of manufactures during the period 1980—87 whose respective growth rates averaged 7.4 percent and 6.3 percent. Such rates of growth are also in line with the World Bank's high projections for the period 1987—1995 for low income countries and exporters of manufactures both being projected at 6.5 percent, although the high projection for the developing world as a whole is considerably less at 5.6 percent.

The resulting current account financing requirement for developing countries as a whole in 1995 has been set by the Bank at $ 52 billion involving net long term lending of $ 64.8 billion. Any more specifically country focussed exercise of the kind under way in WIDER with comparable magnitudes for 1995 and extending to 2000 is bound to yield more ambitious financing magnitudes and it would be interesting to see how far potential surpluses run by major developed countries could without unnecessary discomfort meet the needed capital inflow requirements of developing countries. On the present projections currently available, all one can say is that plausible policy scenarios are available for the developed countries to pursue which will simultaneously generate the surpluses necessary for the "high case" growth scenarios projected by the Bank to be realized by both developing and developed countries.

2. Maintaining growth in the developed countries

I turn now to my second problem, that of maintaining adequate growth in the developed economies whilst simultaneously correcting today's major payments imbalance. It is now widely recognized that the United States cannot continue to run much further into debt without a crisis of confidence in the dollar, with the only corrective available to the U.S. — a substantial rise in interest rates — in turn, bringing about a world wide recession. To the traditional 'failure of confidence' reason for precipitating a world wide recession must now be added the inflation risk reason, and this may well be the more immediate threat. This derives from the continuing investment boom in OECD countries. With U.S. unemployment declining to 5.2 percent — a level approaching its "natural" rate — the risk is now of overheating of the U.S. economy and of inflation, which if not checked early would, via tight monetary policy, also precipitate a major recession.

Just as much as there are recessionary risks in the failure on the part of the U.S. to act to correct its deficit, there are equivalent risks in uncoordinated action by the U.S. alone. Assuming that the desired

correction is in the range often mentioned of $ 150 — $ 200 billion, this is equivalent to 8 to 10 percent of world exports, and a reduction in U.S. import demand of this order must obviously precipitate a major recession in world export markets unless offset by correspondingly expanded demand elsewhere. The conventional wisdom has it that the needed demand expansion should come from the surplus economies, Japan and Germany. If this were to happen, the recessionary impact of the correction in the US deficit would indeed be averted.

Yet, it makes little moral sense for countries which are already at high levels of consumption to be encouraged to consume and import more because this is the most immediate way in which persistent surpluses can be extinguished. It would make far better economic and moral sense to enable these countries to continue to run *moderate* surpluses and through deliberate policy action to recycle a substantial part of these surpluses in support of Third World development.

Three elements are needed by way of coordinated policy action. First, there is a current need for a phased deficit reduction strategy in the United States which does not throw the U.S. itself and the world into recession. Second, there is a need for some offsetting action in surplus economies if only to take up part of the initial slack resulting from U.S. deficit correction. Thirdly, there is the need for devising effective mechanisms to divert to developing countries the savings potential implicit in the difference between the full extent of the U.S. deficit reduction and the moderate expansion in surplus economies. This last element belongs, in fact, in the territory of my third problem, that of exploring the opportunities for combining balanced growth in developed economies with the development of the Third World in the 1990s.

In regard to the phasing out of the U.S. deficit, there has emerged a view[12] that this can be accomplished through a consumption recession in the U.S. which would not provoke a more general recession thanks to the current export boom and the strength of private investment. The consumption recession would result from a cut in the structural fiscal deficit through freezing nominal government expenditures particularly in defence, stretching out the inflation indexation of social security benefits, a rise in the gasoline tax — with a 25 cents per gallon increase raising tax revenues by $ 25 billion — and the introduction of a nation-wide consumption tax. Such a consumption recession will be deflationary on the rest of the world, and the question to ask is how deflationary this impact would be.

In Dr. Yoshitomi's lecture printed in this booklet, he reported the results of a simulation on the assumption that the U.S. budget

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[12] *Op.Cit.* Masaru Yoshitomi.

deficit will decline as a result of a consumption recession, by $ 15 billion each year from 1988 to 1992, compared with the present level of $ 150 billion, making, in other words, for a total reduction of $ 75 billion. On this simulation, the US external deficit would fall to $ 86 billion or 1.3 percent of GNP in 1992. While the growth rate of world trade would be reduced by no more than 0.5 percentage points from the assumed base line of 5 to 6 percent growth, the slowdown of real GNP would be marginal with a decline of 0.3 percentage points in the United States.

Several questions need to be asked about this strategy. First there is no successful precedent in the recent past for the U.S.'s present attempt to tackle a trade deficit on todays scale without sacrificing economic growth in a major way. Even the astonishingly rapid recovery of Japan's balance of payments after the second oil shock of 1979—81, when it shifted resources equivalent to more than 4 percent of GNP into net exports, was accompanied by a slowdown in growth. In particular, a question arises as to whether the pace of adjustment for the United States, outlined by Dr. Yoshitomi, is too slow to provide the necessary assurances to the financial markets. *Per contra,* if the U.S. has for these reasons to adjust faster, then there is a real concern as to how far what was intended to be purely a transitional consumption recession is likely to become or merge into a major and more protracted recession. The answer is that we yet do not know exactly what the fall out would be. I can only say that WIDER has a major research project in hand being directed by Professor Jeffrey Sachs of Harvard University to examine the implications for the rest of the world of alternative scenarios for the correction of the U.S. deficit.

If the path of a consumption recession starting in the U.S. leads to a more generalized global recession, then there is a very clear risk that following the classic path of Keynesian adjustment, *world* income as a whole may fall, including Japan's, so that Japan's excess savings would just not be there to be lent to developing countries tomorrow. The question I am raising simply points to the difficulty of trying to fine tune the world economy in the face of today's uncertainties and the understandable caution of surplus countries.

Countries in surplus have been distinguished by having track records of extremely low inflation, and are understandably wary of embarking upon expansionary policies that might only serve to reignite inflation. Countries in surplus also have a concern about their levels of domestic public debt and about the scale of domestic expansion that can be undertaken without increasing domestic debt to uncomfortable levels. Countries in surplus also have legitimate concerns about the risks to steady economic growth involved in making too drastic a shift from a pattern of export-led growth to a pattern of domestic demand-led growth. It is essentially for these reasons that there are definite limits, viewed from the stand-point

of stable growth in the world economy, to the degree to which domestic expansion in surplus economies can fully offset the deflationary impact of the desirable reduction in the U.S. deficit.

3. Recycling to counter debt and deflation

It is these considerations which lead me now to taking up my third problem, namely, that of marrying the resolution of the developed country payments imbalance and growth problems with finding a satisfactory solution during the 1990s for the problems of the developing countries. Recycling to developing countries of surpluses becomes then the obvious counter to the deflationary impact of a reduction in the U.S. deficit. Indeed, the most ambitious plan put forward for the Japanese surplus is that presented by WIDER. The WIDER plan calls for Japan to adopt over the medium-term a current account surplus target of U.S. $ 50 billion, equivalent to 2 percent of Japan's GNP, which happens incidentally also to be Japan's officially accepted current account target, instead of the $ 80 to $ 90 billion magnitude for her surplus which would be run without corrective domestic policies. The WIDER plan calls for the recycling through deliberate policy action of an amount of $ 25 billion annually, or half Japan's current account surplus target, so that over five years $ 125 billion would be recycled.

The WIDER plan also demonstrates that recycling to developing countries is on average about five times as effective in improving the U.S. trade balance than equivalent domestic expansion in Japan. According to estimates made by Professor Jeffrey Sachs for WIDER, while $ 25 billion recycling would improve the U.S. trade balance by $ 10 billion approximately, an equivalent domestic expansion programme in Japan would improve the U.S. trade balance by only U.S. $ 2 billion.

Similar evidence is available in the Overseas Development Council Agenda for 1988, "Growth, Exports and Jobs in a Changing World Economy". One result of the import compression enforced upon debtor developing countries to adjust has been the collapse of U.S. export markets — exports to developing countries dropping from U.S. $ 88 billion in 1980 to U.S. $ 77 billion in 1985. According to the ODC Agenda,[13] if U.S. exports to developing countries had grown in the first half of the 1980s at the same rate in the 1970s, they would have totalled about $ 150 billion in current dollars. This growth would have created 1.7 million jobs in the U.S. or nearly 21 percent of total official unemployment in 1986.

The question at issue is what alternative exists to a consumption based recession in the U.S. with all the attendant risks we have

[13] *Growth, Exports and Jobs in a Changing World Economy: Agenda 1988,* Overseas Development Council, Washington, D.C., 1988, page 10.

mentioned of its spreading into a general investment recession, in order to enable surpluses to be released for recycling to developing countries. One obvious alternative is whether the evolving world political situation does not permit the U.S. to grasp a range of opportunities for reducing its budget deficit which have been regarded as foreclosed up to now.

A paper by Sam Nakagama,[14] Chairman of Nakagama and Wallace Inc. of New York addressed the issue in an interesting way in June 1988 and deserves to be better known. Mr. Nakagama is a well-known Wall Street economic forecaster with an amazing track record of accuracy including the prediction of October 1987's stock market crash and his audience largely comprised his blue-riband clients. He talked of three magic magnitudes plaguing the U.S. economy, each of U.S. $ 150 billion. Two of these are readily recognisable — The U.S. current account deficits, respectively, in her balance of payments, and in her budget. The third, invisible up to now in public debate, Nakagama reckoned to be the cost of maintaining the U.S. defence commitment to Europe. He wondered whether in the current climate of glasnost, perestroika and detente and European insouciance about any threat from the East, reducing this commitment might not offer a relatively painless solution to the U.S. budget deficit conundrum. This struck me as being relevant radicalism — less far-reaching than most conventional disarmament nostrums, and within the realm of the possible for a new U.S. administration seeking a bold initiative. As I listened in the company of hard-bitten Wall Street bankers who had previously heard an appeal from a former U.S. Navy Secretary, for Japan to step up her defence role to the evident puzzlement of several Japanese present, I had a dream.

A phased reduction in the U.S. deficit through relaxing her commitment to Europe would free Japanese savings to flow to developing countries in ample and hitherto unprecedented volume. A debt reconstruction facility, setup on a Japanese initiative, would be allied to what I have described as self-reliant conditionality — i.e. reform packages that *countries* would design for *themselves* in consultation with the international financial institutions — or for that matter a Japanese Trust Fund — for the first time in recent memory on a basis of sufficient finance. This would help defuse the tensions that currently exist between countries and the international financial institutions, which in large part stem from the use of conditionality to ration today's grossly inadequate volume of finance. Policy reform, accompanied by substantial programme lending and the resulting dynamism in the Third World, would create both project development and private investment opportunities on a scale that could usher in for the developing countries during the

[14] Sam Nakagama, "Mathematics of a Falling Dollar: $ 150 Billion Budget Deficit, $ 150 Billion Trade Deficit, $ 150 Billion a Year for Nato", Nakagama & Wallace Pacific Basin Seminar, New York, 29 June 1988.

1990s, the kind of Golden Age that Europe enjoyed in the 1950s and 60s in the wake of the Marshall Plan. Structural change in the U.S. economy and in Europe following detente, could reorient industrial capacities in the advanced economies in a manner that would meet the vast unmet needs of the Third World, and reduce if not eliminate today's substantial levels of European unemployment. In short, a virtuous circle could be set in motion by thinking what until recently has been the politically unthinkable.

In the cold light of day after Nakagama's presentation, I tried to do the homework needed to test out this intuition. The $ 150 billion magnitude for NATO mentioned by Nakagama turns out to be about half the nearly $ 300 billion appropriated for all U.S. defense expenditures in 1989, according to the report presented by the Secretary of Defence to the Congress on February 11, 1988.[15] Two categories within this $ 300 billion expenditure — for Procurement, and Research Development, Test and Evaluation — distinguished in the report, total around $ 120 billion and provide a rough measure of the weapons production capacity of the United States. Assuming that half this amount *pro rata* represents the capacity of the U.S. arms industry attributable to NATO related purposes, then the Nakagama proposal can be expected to release something like $ 60 billion of U.S. industrial capacity to meet the Third World's unmet needs.

The industrial capacity released by the Nakagama proposal for Third World use in the U.S. alone of $ 60 billion amounts precisely to half the combined surplus of Japan and West Germany expected for 1989, of $ 120 billion. Since even the most ambitious proposal so far made public for recycling the Japanese surplus — the WIDER Plan — also envisages that no more than half her expected surplus should be recycled through deliberate policy action for Third World purposes, the proportions revealed by this piece of homework do not appear implausible.

The *Financial Times* said almost all, in its usual inimitable style, when commenting on July 7, 1988, on the 1988 World Development Report:

[15] I am grateful to Professor Emma Rothschild for her very valuable assistance in looking further into these magnitudes.

> "The report could surely have been more radical in its analysis of global macroeconomic adjustment, which repeats the conventional call for reduced current account surpluses in countries like Japan, Germany and Taiwan. For the World Bank, a more appropriate and innovative approach would be to welcome the surpluses, but complain about where they are going. What is needed is a call for developed countries to take a far more radical approach to the liquidation of developing country debt, for the U.S. to stop hogging the world's surplus capital and last but not least, for developing countries to undertake the fundamental reforms which will encourage renewed capital flows from the rich to the poorer countries of the world. If the world's premier development finance institution cannot articulate such a vision, how are the developing countries ever to escape the whirlwind?"

I am not presuming to say that it is only WIDER that has stepped in where the World Bank has feared to tread. Japan, too, must be counted on the side of the angels in so far as, in addition to the proposals already made public, as well as the continuing rise in foreign aid, active thought is being given within the Government to more ambitious plans for recycling surplus savings to developing countries. But it would be idle to pretend that in the absence of coherently articulated views from outside of the major summit countries such recycling plans can attain their full potential. We have seen at the Toronto summit and more recently at the World Bank annual meetings of 1988, Japan's initiatives being either shelved or muted for a variety of no doubt understandable reasons. What the present situation cries out for is a *political* constituency outside the Summit group of five countries that could act as a pace-maker for change to which it would be open to Japan, for example, to respond. It could develop a platform that would point to the opportunities available through recycling surpluses for energizing world development. More ambitiously it could build up the momentum for rewriting the rule book governing international economic behaviour at a time when *ad hoc* mechanisms are still very much in vogue.

There is in fact yet another WIDER plan to give effect to precisely this design. The WIDER Plan would establish a fully articulated Group of the Non-Five that would function as a counterweight to the Five summit countries. The plan goes back to a meeting held in Helsinki in March 1986 to explore possible areas of mutual interest among medium sized economies involving representatives from 15 developed and developing countries — the "Middle Powers". The plan has been elaborated by Dr. Stephen Marris, WIDER's Research Adviser on issues relating to the governance of the world economy working in close consultation with me.[16] The Group of the Non-Five would address the entire range of issues pertaining to the management of the world economy and the activities of all the

relevant international organizations. It would entrust decision making to a limited Executive Board realistically of no more than ten members chosen on the basis of a weighted voting formula analogous to that in the Bretton Woods institutions. The difference is that with the Group of the Non-Five, country quotas determining voting rights would be based *entirely* on three *objective* criteria, trade, GNP and population.

The Executive Board would allow illustratively, for three members each from Europe, and Asia and Oceania, two from the Western hemisphere including Canada, and one each from Africa and the Middle East. Illustratively again, in Europe, there could be two European Community constituencies, and another primarily made of Eastern European and neutral countries. In Asia and Oceania, there might be two constituencies formed under the leadership of India and China, and a third Pacific Rim constituency including Australia and New Zealand. In the Western Hemisphere, Canada might join in a constituency including Central America and the Caribbean, as is indeed partly the case today in the IMF, with a second South American constituency. There would be provision for the USSR to join as an observer from the outset with full membership resulting from a further decision to join either GATT or any of the Bretton Woods institutions.

The objectives of the Group would be as follows:

1. To loudly and persistently lobby for representation in the G5 Summit. The new Group would announce from the outset that, if invited, it would be prepared to designate one or more of its members to participate in the Group of Five and Summit meetings.
2. To develop joint positions on all the main issues pertaining to management of the world economy — exchange rates, interest rates, finance, debt, trade, etc.
3. To demonstrate, by its own mode of operation, the possibility of developing an efficient (i.e. small) but representative vehicle for discussion and negotiation on the major issues of international economic cooperation.
4. To resist, by all possible means, further erosion of the multilateral institutions resulting from the increasing tendency of the Group of Five and the Summit to take key decisions outside the existing multilateral framework. This could include using the considerable influence that the Group would have within these organizations to try to ensure that relations between them and the Group of Five and the Summit were not just a one-way street, as is to a large extent the case today.
5. To develop proposals for a major reform of the existing international institutional framework. Proposals for monetary reform would, I imagine, command a very high priority in this context. What is needed is a new international monetary system designed

and developed in order to avoid unduly large swings of exchange rates over the medium-run which distort international resource allocation and strengthen protectionism in the countries with over-valued currencies. Additionally, the Group would be an effective sounding board for any new mechanism Japan might develop whereby macroeconomic discipline can be imposed on the key currency country.

Above all, the Group's mandate would lay out very clearly its essentially *political* objective of providing a counterweight to the Group of Five. In doing so, however, it should be stressed that the aim is not to create a new division between "them" and "us", but rather to mobilize pressures to narrow and eventually bridge the gap. Thus, the ultimate aim of the new Group would be to make itself redundant. For what the Group would be dedicated to is to establishing a truly international mode of governance for the international institutions of the 21st century.

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[16] Stephen Marris, A Proposal to Create the "Group of the Non-Five". A paper prepared for WIDER's project on the Governance of the World Economy, and printed as Appendix A in WIDER Study Group Series No. 4, *World Economic Summits: The Role of Representative Groups in the Governance of the World Economy,* Helsinki, 1989. The remainder of this section draws extensively on the text and analysis of this paper and, in effect, summarizes the proposal.