**Overseas Development Institute**
Regent's College, London NW1 4NS
Tel: 01-935 1644
**Briefing Paper**
**4: November 1985**

# THE PROSPECTS FOR ECONOMIC RECOVERY

*All this year's forecasts by the international agencies agree on the same gloomy picture that they presented last year,[1] of sluggish growth in the industrial countries continuing into the next five years, leaving them with a high margin of unused capacity and high unemployment, and offering no stimulus for a recovery in the developing countries. What stands out is the doubt expressed by most of the forecasters on whether the path that they project for developing countries is a credible one. This year their publications (see Box) give much more attention to the consequences of this outlook and to the policy options that could prevent or ameliorate it than to the derivation or details of the forecasts. The most interesting disagreements lie in how they define and analyse the problem facing the developing countries. Three approaches can be identified: adjustment to the unfavourable conditions; limiting or avoiding the effects, principally by increasing or finding new forms of external finance; and looking at the development requirements in total and for individual sectors, attempting to go deeper than a macroeconomic, demand-based relationship between developed and developing countries. This shift in emphasis towards looking more closely at the results of the forecasting exercise has brought more analysis of how countries have differed in their ability to respond to the crisis since 1982.*

## The Forecasts

### The industrial countries

The performance of both industrial and developing countries in the second half of 1984 was better than had been expected, but this marked the end of rapid growth and industrial recovery in the former. Since then, there has been very slow growth or stagnation in most output and trade figures. In 1985, **output** appears to have increased even less than expected, slowing from 5% in 1984 to (on the most recently revised forecasts) less than 3% (Table 1). If, as expected, this continues into 1986, the European countries will have had three years of 2-2½% growth. The major explanation of the change from 1984 to 1985 is the collapse of US growth, from almost 7% to under 3%.

**World trade** growth in 1985 is now estimated at 3%, after 9% in 1984 and forecasts last spring of 5-5½%. The industrial countries are now increasing their imports at only about the same speed as their exports instead of more rapidly as in the recent past. This greatly restricts the opportunity for the developing countries in aggregate to raise their share of world markets. Most forecasters expect exporters of manufactures to be able to achieve this, but only at the expense of primary exporters (including the oil exporters).

In 1984 the industrial countries increased their imports by some 12% (about 2½ times as fast as output growth), mainly because US imports grew almost 25%. The other industrial countries also had high ratios of import to output growth. The principal reason that total trade growth has fallen more than proportionately to output in 1985 is the fall in US output; its imports have continued to rise more than three times as fast as output. Although the forecasters do not give their trade forecasts for the medium term, they probably expect world trade at 5-5½%. Within this US imports are expected to continue to grow faster, with higher output and higher import elasticity; although reduced, the stimulus will still be mainly towards its trading partners, notably in Latin America and Asia.

The assumptions that output in industrial countries will grow slowly and that import elasticities will fall are critical to the outlook for the developing countries, and they are closely linked. Low growth is believed to discourage imports directly, because low capacity utilisation reduces

[1] ODI Briefing Paper 1984:4, *Economic Prospects for the Third World: 1984.*

### FORECASTS DISCUSSED AND PRINCIPAL DEFINITIONS

#### Forecasts

General Agreement on Tariffs and Trade, *International Trade,* September, GATT.

Inter-American Development Bank, *Economic and Social Progress Report,* September, IDB.

International Monetary Fund, *World Economic Outlook,* April and revisions announced in October, IMF.

Organisation for Economic Cooperation and Development, *OECD Economic Outlook,* July, OECD.

United Nations, *World Economic Survey,* April and revisions announced in October, UN.

United Nations Conference on Trade and Development, *Trade and Development Report,* September, UNCTAD.

World Bank, *World Development Report,* June, World Bank.

UNIDO, *Industry and Development Global Report,* June, UNIDO.

#### Definitions

Oil price: average OPEC official export price; 'real': deflated by price of manufactured exports.

Price of manufactured exports: UN index for developed countries.

Price of primary exports: UNCTAD index, market prices of developing country exports.

*All the published projections are called 'forecasts' here although some agencies call some of their numbers assumptions, scenarios, etc.*

**Table 1: General Forecasts for 1985-90 percentage growth rates**

| | 1985 | | | | | 1986 | | | | 1987 | 1987-90 | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | IMF | UNCTAD | UN | WB | OECD | IMF | UNCTAD | UN | OECD | UN | IMF | WB high | WB low |
| *Industrial Countries* | | | | | | | | | | | | | |
| Output | 2.8 | 2.5 | 2.2 | 3.1 | 3.25 | 3.1 | 2.5 | 2.5 | 2.75 | 3.8 | 3.1 | 3.5 | 2.7 |
| United States | 2.6 | 3 | 2.5 | | 3.25 | 3.3 | 2.8 | 2.5 | 2.75 | 4.5 | 2.9 | | |
| Europe | 2.3 | 2.5 | 2.5 | | 2.25 | 2.5 | 2.4 | 2.2 | 2.25 | 2.6 | | | |
| Unemployment rates average | 8.2 | | 7.1 | | 7.25 | 8.1 | | 7 | 7.25 | | 7.2 | | |
| Import volume | 6.1 | 6 | 6 | | 5.25 | 4.7 | 4.9 | | 5.5 | | | | |
| US import volume | 11.1 | 9 | | | 6.25 | 5.8 | 5 | | 7.25 | | | | |
| World trade | 3.5 | 5.6 | 4.5 | | 5.25 | 4.3 | 4.8 | <4 | 5.25 | 4.5 | 5.3 | | |
| *Prices, Interest Rates, and Exchange Rates* | | | | | | | | | | | | | |
| GNP deflator | 3.9 | | 4.2 | | 4.5 | 3.7 | | | 4.5 | | 3.7 | 7.5 | 4.5 |
| Change US$ effective | 3 | | <0 | | 11 | 0 | -3 | <0 | 0 | 0 | -5 | | |
| 3 month LIBOR defl.US GNP | 5.5 | 6 | | | | 5.2 | | | | | 3.5 | 2.5 | 6.5 |
| Price US$ | | | | | | | | | | | | | |
| Manufactured exports | -2.0 | 2.3 | 0.5 | | -4 | 6.0 | | | 3.75 | | 7.5 | | |
| Oil price | -4.0 | | -2 | | -2.25 | -1.0 | | | 0.5 | | 7.5 | | |
| Primary products | -11.2 | -9.5 | -1 | | -8.5 | 1.5 | | | 2.1 | | 7.5 | | |
| Food | -14.2 | -5 | 0 | | -6.7 | -0.3 | | | 2.4 | | | | |
| Tropical beverage | -12.4 | | -3 | | -10 | 0.4 | | | 0.9 | | | | |
| Vegetable Oils | | | -12 | | -13.2 | | | | | 2.8 | | | |
| Agric. Raw Mats. | -13.3 | -2 | -4 | | -6.8 | 2.1 | | | 2.1 | | | | |
| Minerals, ores, metals | -2.3 | 1 | 1 | | -4.3 | 5.2 | | | 2.2 | | | | |
| *Developing Countries* | | | | | | | | | | | | | |
| Terms of trade | -2.0 | -2.6 | -0.5 | | 0 | -2.3 | -0.5 | | -1 | | 0 | | |
| Import volume | -0.1 | 2.3 | 4.5 | | | 2.7 | 5 | | | | 7.0 | 8.8 | 2.4 |
| Export volume | 0.3 | 4.5 | 5.5 | 7.4 | | 5.0 | 4.6 | | | | 5.9 | 6.7 | 3.5 |
| Exporters of manufs | 5.4 | 9.1 | | 7.5 | 8 | 6.2 | 7.3 | | 5 | | 6.5 | 10.4 | 5.4 |
| Output | 3.5 | 2.8 | 2.6 | 3.7 | | 4.1 | 3.7 | 3.6 | | 4.3 | | 5.5 | 4.1 |
| Oil Exporting | 0.3 | 1 | 3 | 1.9 | | 2.7 | 2.8 | | | | | | |
| Non-oil developing | 4.5 | | 3.5 | 3.7 | | 4.5 | | | | | 4.9 | 5.5 | 4.1 |
| Major exp. of manu. | 2.8 | 4 | | 2.5 | | 3.8 | 4.7 | | | | 4.6 | 6.4 | 3.8 |
| Low-income | 7.8 | 3.1 | | 6.7 | | 6.1 | 3.2 | | | | 5.8 | 5.6 | 5.2 |
| Western Hemisphere | 2.5 | 2.4 | 2 | | | 3.3 | 3.4 | 3.5 | | 4.5 | 4.5 | | |
| Africa | 2.2 | 1.5 | 3 | 2.3 | | 3.1 | 2.4 | 3 | | 3.5 | 3.8 | 3.4 | 2.5 |
| Asia | 6.8 | 5 | 4.5 | 7.4 | | 6.0 | 5.25 | 5 | | 5.5 | 5.9 | 5.8 | 5.4 |

the need to find alternative sources, and indirectly, because high levels of unemployment and slow growth stimulate protection.

## Prices, interest rates, and exchange rates

Primary **commodity prices** are still depressed in dollar terms (at roughly 1976-77 levels). They did rise relative to other prices in 1984, but most forecasters believed that they would fall back in 1985, and little change is expected in 1986 or beyond. UNCTAD argued in its report that one reason for this trend is that they have risen relative to other prices in developing countries, which has led to increased productive capacity. It suggests that IMF and World Bank encouragement of new producers directly and by raising their returns by freeing prices and currencies could reduce export income for all producers if price elasticities are (as normally assumed) low, although individual countries could benefit through substitution of suppliers. In its revised forecasts, the IMF also warns about this possibility.

The inflation and interest rate forecasts offer the worst combination for the developing countries: low inflation and high real interest rates. **Inflation** in the industrial countries is expected to remain at around 4%. The forecasters all expect **real interest rates** to fall from their current level of around 6% but to remain high (at least 4%). The UN points out that measured against the export prices of the developing countries, more relevant to their ability to service debt than the conventional measurement against US prices, the real interest rate has been much higher than this in recent years, as these export prices have fallen.

None of the forecasts explores fully the way in which interest rates, trade prices, and the debt burden interact, even though the size of debt repayments is recognised as crucial to whether the forecasts do represent a feasible outcome. Inflation reduces the cost of any payment fixed in money terms. Although a growing proportion of developing country debt has been incurred at floating interest rates, which rise with world interest rates, and are related to the inflation rate, it remains true that inflation reduces the burden of repaying non-floating debt. Therefore, as long as the proportion of debt at floating rates is less than the ratio of exports to total debt, even if inflation is fully reflected in changes in nominal interest rates (which experience suggests is unlikely), higher inflation lowers the costs of debt servicing. For all classifications of developing countries the relative values of the two ratios are favourable (although for a few individual countries, including Argentina, Brazil, and Costa Rica, they are not). The groups and areas with the highest debt ratios do not have the highest floating rate ratios. The advantage of higher inflation would be greatest for the poorest countries, especially in Africa.

## Financial flows

The forecasts agree that the quantity of external finance available over the next five years will be much less than in the past. It will be lower in relation to trade, domestic output, or saving, and grow very slowly, if at all (Table 2). Its composition will be more heavily weighted towards official flows and direct investment. Its distribution will be more concentrated, on the limited number of NICs that attract investment, on the few remaining countries considered credit-worthy by the commercial banks, and on the poorest.

Official **aid** flows are not expected to increase significantly. New **credits from the IMF** itself have fallen sharply this year; they were less than repayments in the first quarter, and the IMF expects net repayment to continue in 1986. Although there has been much discussion during the last year in international agencies and by the US and British governments[2] about the potential importance of private equity flows, and how to encourage these, the forecasts and analysis, especially by the IMF, suggest that expectations have now been lowered. **Direct investment** is expected to grow at about 3% a year, as it did in the 1970s. Neither changes in policy by developing countries nor international schemes to encourage it are expected to increase it significantly.

The forecasters expected a sharp fall in **bank lending** in 1986, and no significant rise thereafter. The 1985 record, so far, appears worse than forecast, with no net 'voluntary' lending to those with debt problems. All the forecasters expected the present system of 'involuntary' lending, under which the banks lend under the direction of the IMF and their central banks, to end this year, but that the banks would maintain existing arrangements.

## Developing countries' trade

The most recent forecasts suggest that developing countries' **terms of trade** fell in 1985 (Table 1), more than balancing the small rise in 1984. All expect little or no improvement in the medium term, even if there is relatively good growth in the industrial countries, with a risk of further falls. The volume of exports by the developing countries rose much faster than total world trade (or than forecasters expected) in 1984, at about 12%. This was mainly accounted for by exporters of manufacturers, and among these, by the East Asian countries.

The 1985 forecasts predict a much lower rise than in 1984, and at best no change in the share of non-oil exports. In the medium term all non-oil developing countries are expected to do only slightly better than the sluggish rate for world trade. The countries that do not at present have debt servicing problems would continue to achieve the highest export growth rates, while countries relying on official finance, the poorest, have the poorest export prospects.

[2]ODI Briefing Paper1985: 1, *Foreign Investment in Developing Countries.*

### Table 2: Financing current deficits of indebted countries

| | 1984 | 1985 | 1986 | Annual Growth Rate 1987-90 | 1990 Base |
|---|---|---|---|---|---|
| | (U.S. dollars billion) | | | | |
| Current deficit (U.S. dollars billion) | 37.9 | 43.6 | 42.7 | | 75.9 |
| | (percentages) | | | | |
| Official transfers | 36.7 | 40.8 | 38.6 | 0 | 27.1 |
| Direct investment | 27.4 | 24.3 | 27.4 | 3 | 21.8 |
| Net long-term | 50.1 | 98.2 | 26.7 | 0.5 | 14.4 |

Source: IMF, *World Economic Outlook.*

## Output and inflation in the developing countries

In 1984, **output** in the developing countries grew by 4-4½%. They are not expected to achieve this rate again within the forecast period. In 1985, the early forecasts were for around 3½% but these have been downgraded to 2½%. Most expect this rate to continue into the medium term. Within it, the spread among the different areas and types of developing countries is forecast to diminish but the poorest and the exporters of primary goods are expected to continue to do least well. As UNCTAD emphasises, this output growth would leave many developing countries at or below 1980 per capita income levels for (at least) the next five years.

All the forecasters assume very low **import elasticities,** especially in the worst hit countries. If countries cannot make such large adjustments to mitigate the constraints of low external demand and low access to finance, the output growth permitted could be under 3%.

**Inflation** has been much higher than in past recoveries, even though the recovery has been weaker, and it has continued to increase in 1985, particularly in Latin America. This has occurred in spite of depressed capacity utilisation and employment levels in the developing countries and declines in world trading prices. The UN and UNCTAD blame the currency devaluations required by the adjustment packages imposed by 'international banking and lending institutions', and also the pressures caused by the need to reduce the claims of different groups on falling national income. Even the IMF accepts that the latter is a problem. Inflation in turn makes the functioning of the economies more difficult.

## The slow growth cycle

Slow growth may thus itself create conditions which worsen the prospects for future growth. This is one reason why the organisations this year question whether present trends can continue into the medium term, as their own forecasts assume. Making this type of assumption contrasts sharply with previous forecasts: medium term projections have often assumed substantially improved policies and performance. It may seem easier to justify forecasts that assume unchanging average-to-low growth in all countries, average world trade, no change in trade or shift in market shares, and no changes in policies or targets, internationally or at the national level. But while this may be realistic in the short-term, these are medium term forecasts. Such assumptions therefore display a deep pessimism about the possibility of change, even when the consequences are clearly undesirable for all countries. The reasons for what, in the medium-term, is clearly irrational behaviour are not self-evident, and no justification is found in these publications. These forecasts therefore lack a firm analytical foundation.

## Questioning the forecasts: Are they feasible?

The forecasters ask whether the constraints imposed by low growth in the industrial countries, limited new finance, and the burden of servicing existing debt, permit a consistent solution at a low level of growth in the developing countries. Doubt may be based upon economic or political/social inconsistencies.

### Economic doubts

—The possible inconsistency between short term stabilisation and growth because of inflationary effects has been mentioned.
—UNIDO, the UN and UNCTAD, and the IDB stress the direct damage of low output, caused by adjustment constraints to investment. The share of investment in output, which rose in developing countries in the 1970s, has since fallen back.
—UNIDO documents how the most modern and potentially most rapidly growing industries have been worst hit by lower output and investment.
—In the medium term, a further problem arises from the type of policies supported by the IMF and World Bank. If private external finance, in the form of direct foreign investment, is even to maintain its past rates of expansion, and if domestic finance is to be mobilised in order to replace the reduction in other sources of investment finance, investors must be offered adequate incentives. The slowly growing economies pictured in these forecasts are unlikely to do so.
—Shifting more resources into exports when world trade and the markets for developing countries in particular are growing slowly poses similar problems.
—Diversifying into different primary products or devaluing to promote manufactures may help one country on a short-term basis, but the total market is limited.

### Political doubts

—Structural adjustments may be delayed because moving out of industries that normally decline as countries develop is more difficult when total output and employment are growing slowly or falling, in developing and industrial countries alike. This may affect countries' development directly through domestic policies; indirectly through protective measures by others.
—To make net repayments requires adjusting not merely to the absence of external finance, but to making net transfers to the advanced countries. To make adjustments to output and investment that damage growth, and which may also require transfers from the poorer to the less poor groups within countries, puts pressure on countries' social and political systems, again without offering any long-term reward.

Some of the forecasters explore how the puzzle is to be solved, looking in particular at whether financial or more fundamental changes are needed, but none incorporates the problem into a forecast.

### Financial solutions

Up to now these have been the principal reaction to the debt crisis. Most of the forecasters suggest that more external finance is desirable to permit recovery and to cushion shocks. **Rescheduling** debt repayments assumes that in some future period exports will be high enough, or the level of interest rates will be low enough, or new external finance will be available, so that the countries will then be able to repay what they cannot at present. On these forecasts, that time does not ever arrive. Even if it did, this would not meet the incentive problems outlined above. Rescheduling negotiations appear to have implicitly assumed that repayment would itself attract new finance. On these forecasts, repayment (which is assumed) does not bring in new money.

Some of the forecasters discuss the potential for greater **'securitisation'** of financial markets. By this is meant a variety of financial innovations which normally require banks to arrange finance for bonds issued by developing countries (or other risky borrowers) to investors, but not themselves make loans on the basis of deposits. The bonds may include new devices such as floating interest rates or variable maturities (including 'perpetual' bonds). The immediate purpose was to reduce the risk to the banks from further loans to risky debtors, but the schemes are also seen as reducing risk generally and therefore encouraging more capital flows. But as with the syndication of loans among many banks in the 1970s, new schemes cannot affect the actual risks of the underlying loans or projects. They can only alter the distribution of risks among the lenders. Variable interest rates shift the risks of **higher costs** to the borrowers, but not those of inability to repay. If new instruments alter lenders' perceptions of risks, either through offering a spread of small assets with the apparent advantages of diversification or because they have too many commitments to be fully aware of the risks attached to each, they could increase lending.

If the assumptions on which existing financial solutions rest are not valid, if there will be no significant new finance from either new or existing sources and if repayments are not feasible under present conditions, this leaves a high degree of uncertainty in the forecasters' net financial projections. They do not explore how one could set repayments in terms of what a country can repay by some economic criterion, or believes that it can repay, in accordance with its own economic targets or its perceived political or social constraints, although such considerations are clearly influencing what is being repaid in practice. The IMF does note that further rescheduling will be necessary, and UNCTAD argues that only writing off some of the official and private loans (with partial compensation to the banks) can solve the problem. Neither estimates the consequences of much more drastic rescheduling or writing off of the debt for the industrial countries, or for future financing.

### Structural solutions

UNCTAD and UNIDO explicitly conclude that any purely financial solution would be insufficient without more rapid growth (a minimum of 3 ½%) in the industrial countries; World Bank and IMF simulations of alternative paths support this; different policies in the developing countries have much less effect on the outcome. Nevertheless, they do not offer any strategy, for encouraging or directing developed countries to achieve faster growth, but they do consider policy choices for the developing countries. The IMF and World Bank suggest the policies normally included in their lending conditions, including greater use of prices, emphasis on the private sector as an efficient decision-maker, and, in the medium term, promotion of exports and external openness. Other forecasters, notably the IDB, explicitly question these. The IDB criticises any strategy that looks for a single solution. In external adjustment, it argues that more attention should to be given to changes in the components, not merely to the overall balance, because these have different implications for future development. It questions whether there is firm evidence for the success of export-led strategies in the past.

In 1985 the forecasts were condemned in the Reports themselves as unsustainable. The organisations did not believe that financial solutions existed. They did not consider it possible to achieve the only realistic solution, faster growth in the industrial countries. They did not consider that any action that could be taken by the developing countries alone (or together) would be sufficient, and did agree on what they should do to ameliorate matters. This was itself a remarkable contrast to the complacency of public pronouncements in Spring 1985. The UN has recently accused the Development Committee meetings held then of having given false hopes to the banks that transfers could continue and to the developing countries of 'better days in the 1990s'.

## Recent developments

### Background to the US initiative

Since the forecasts were prepared, events have fuelled doubts about their feasibility, while policy developments have reinforced the need and the acceptability of international intervention.

The evidence on trade performance in the first quarter made the forecasts for 1985 look optimistic. Exports may have fallen, especially for the NICs and debtors, and commodity prices have fallen much more than had been expected. The IMF forecast in April had been 5.5% for developing countries' exports in 1985; it is now 0.3; for commodity prices, it has changed from +2.3% to −11.2%. In September GATT suggested world trade would grow by less than 4% this year. The World Bank reported that its lending had fallen by 5% in the year ending June 1985, because of 'the continuing stagnation in many developing countries and uncertainty in the financial markets' and the poor creditworthiness of major borrowers. This was to add a further twist to the cumulative process of poor growth damaging future capacity.

Debt repayment became openly unrealistic as Peru and Brazil both announced that their repayments would be limited by national criteria; Mexico, the only country to achieve a formal multi-year rescheduling arrangement (signed at the end of August 1985), found itself in need of further rescheduling and threatened with IMF withdrawal of further finance (in September) while suffering a natural disaster that illustrated how fragile even successful solutions could be. The Latin American debtors also emphasised, in UN debates at the end of September, the problems caused by protection in the developed countries and by the policies recommended by the IMF and World Bank. Non-Latin American debtors became more obvious problems, including Nigeria and debtors within the industrial countries, notably the farm sector in the US. And it was in September that the IDB report, with the first criticisms of the IMF and the World Bank by name by another agency, appeared.

The agreement of 22 September among the finance ministers of five major industrial countries to co-operate to reduce fluctuations in exchange rates and to alter the value of the dollar was a major change towards accepting policy intervention in international markets. This was its most immediate influence on the prospects for the developing countries; it will also help them directly if the dollar does fall or the European countries do expand more rapidly.

Two agencies did not appear to join in these moves. The World Bank, immediately before the opening of the Joint Annual Meetings of the Fund and the Bank in Seoul, Korea, in October, explicitly refused to accept a general role as guarantor of bank loans to developing countries. The IMF *Annual Report*, representing the official Fund view, took a stronger line on the need for adjustment policies in the developing countries than the *Economic Outlook* (produced by its technical staff). In spite of the drastic revisions which the IMF announced in its 1985 forecasts, and further reductions in export volume and price prospects for 1986, it rejected any major change in its medium-term forecast. Under its new forecasts, however, the debt-export ratio rises in 1985 instead of falling, and by 1990 is 131 (the level of 1981-2) instead of 108 (less than 1980).

### The US proposals

The financing proposals made by US Treasury Secretary Baker at the Annual Meetings have to be seen in the context of the other measures involving the World Bank that emerged at the Annual Meetings and of the general direction of US policy. The emphasis of the proposals has been on the leverage effects; the availability of these funds should encourage other new lending, and, implicitly, deter creditors from demanding repayment. This is clearly the only hope that the proposals will succeed in alleviating a crisis involving debts which dwarf the new flows. The measures include direct financing and private financing through 'encouragement', in some cases extending to guarantee. All are targeted explicitly on the next three years.

The US has agreed to participate in the eighth replenishment of IDA, the soft loan division of the World Bank, (effective from 1987) at a higher level than in the seventh. In 1984, it opposed any increase in funds. The difference could make a small, but positive, change to the expectation for aid flows by raising IDA funds from $10.7 to $12 billion, which is at least equivalent to constant real value. An increase in financing through the IMF Trust Fund could permit net lending by the IMF to continue, adding at least $3 billion to available finance.

The World Bank and the regional development banks will be encouraged to lend an additional $10 billion over the next three years. Apparently most of this is to come from existing resources, not fully used last year. The World Bank has accepted this target as realistic; it had relaxed some of its conditions, on local finance, on upper limits on project loans, and on its exposure to any one borrowing country, and committed itself to accelerate its disbursements.

Increased bank financing is proposed for fifteen middle income debtor countries. The financing would, it is emphasised, be conditional on recipient countries' policies: to promote growth, adjustment, and inflation control (in that order). All US statements about the plan have emphasised growth. The IMF has also now moved to stress the need for growth. After the Baker proposals were made, the Managing Director of the IMF changed the Fund's emphasis, saying 'The debtor countries must grow out of debt.'

Private banks are to increase their new lending, from effectively 0 in 1985 to $20 billion in 1986-8; the implied annual rate is not very different from the assumptions for 1986 (e.g. $8 billion in the IMF forecast) but fears had been expressed that there would be no voluntary net lending. US banks are being 'encouraged' to lend by the US government; they are expected to provide a third of the lending. The response has been favourable from the large US banks which had begun to accept publicly even before the government initiative that some solution that went beyond rescheduling was necessary. Whilst the additional $20 billion is small in relation to banks' existing debts, it constitutes a significant reversal of efforts to reduce their exposure.

A further stimulus to bank lending could come from new World Bank measures, to guarantee bank loans or make joint loans. It has experimented with different formulae this year, but it is not clear how any would fit in with BIS worries over new forms of lending and liabilities.

The Annual Meeting approved the World Bank's proposal for a Multilateral Investment Guarantee Agency (MIGA), to reduce political risks to direct investment, and its co-financing arm, the International Financial Corporation, is attempting to promote portfolio investment through managed funds. These have been on a small scale, and, like direct investment, entirely in the small minority of the most advanced developing countries. No allowance for these World Bank measures was made even in the Bank's own forecasts.

### Financial effects

If the more pessimistic fears of the forecasters about bank and official finance were right before October, the US initiative has at least put the forecasts for bank lending back on course, and provided grounds for believing them while adding a few billion to those for official grants and loans. It is possible, however, that by effectively extending involuntary lending and thus strengthening the implied commitment to ensure financial flows to the developing countries when markets falter, it will reduce the perceived risks to the banks of keeping existing debt on their books and of making new loans. The same reduction in uncertainty and any increase that the higher financing may permit in developing countries' expected growth rates must improve incentives to investors, but, as the forecasters stressed, the effects of financial measures cannot be sufficient on their own. But there are potentially more powerful effects.

### Confidence effects

The US intervention can be viewed as a much more fundamental change in the prospects for the developing countries (and also the industrial). It recognises, like the exchange rate initiative that preceeded it, that governments do have a role in ensuring that the conditions for growth are attained, and in directing private decisions when these are not consistent with long-term growth and where there is no market incentive for the private sector to take the right decision. In the Baker initiative, the US accepts a role for the US government in directing US banks and also (in the absence of effective international action) the world finance system. The objectives may be largely to help the US banking and the US exporting sectors (although the replenishment of IDA at least goes beyond this) but as this is interpreted to mean improving growth in the developing countries, and a rediscovery of international linkages, it is a possible base for an internationally beneficial programme. If the acceptance of government responsibility for economic performance is not reversed, if it is successful in its immediate aims, and if it is perceived as a return to the commitment (even though from a very different point of view) accepted by governments in the 1960s to prevent excessively harmful shocks to their economies, it could sufficiently increase the confidence of private decision makers, in particular of investors, to break out of the circle of slow growth leading to worse performance. For this optimistic interpretation to be credible, the initiative must be part of a consistent policy. On the international finance side there is the change in exchange rate policy. On trade, it may be possible to interpret the recent strengthening of the US stand against protectionism and support for GATT negotiations as further indications that there is a commitment to growth rather than to adjustment to stagnation and high unemployment. There is not yet any evidence that other countries have changed their assumptions or policies, however.

## International institutions

From 1982 until summer 1985 the IMF and the World Bank had probably been extending their roles: their share in financing had increased (except in 1985 for the IMF) because of the contraction of alternative sources of funding and both also took the debt crisis as an opportunity to expand their functions of advising and directing the developing country governments and those who lend to them. It is clear that the initiative has now shifted to the US. For the US to be insisting that the Bank increase its lending is a remarkable reversal of the international agencies' position in their forecast that they can do nothing but point out good policies to the industrial countries. Peru in its very different initiative explicitly demanded direct negotiations with its creditors. The failure of the solutions of the last three years and more specifically the failure of the Bank and the Fund to mobilise resources (or even to spend their own) or to stimulate appropriate policies in the industrial countries, may have led countries to question their role. In addition, the questioning of their policies in the UN and IDB reports is a public breaking of the consensus, on short or medium strategies. This in itself weakens such strategies: willingness to carry on immediately painful adjustment policies rests at least in part on faith, that there is no alternative and that there will be a reward.

Imposing IMF policies on some borrowers raises the same issues that have surfaced in discussion on international financial systems since Bretton Woods: it is only countries which need finance that can be forced to take advice, although many of them may be suffering more from external or natural shocks than from bad policies; and many countries that do not need international loans may have 'bad' policies, even in the restricted IMF or World Bank sense. The resulting deflationary bias to the international system may now be more serious than before if more countries are affected, and if low outcomes may produce an unstable or downwards spiralling solution.

## Conclusion

The type of forecasts presented this year, and the agreement among the forecasters that their results are not feasible, but that they can offer no policies to improve these prospects, can only confirm that the development process, the role of policy, and the nature of international linkages are still imperfectly understood. This could imply that any new initiative should be treated with caution. But the origins of the debt crisis, and the 'unsustainability' of the present position lie at least in part in a loss of confidence: in predictable and growth-preserving government intervention, and in normal conditions in capital markets. The US intervention addresses these problems more directly than any other solutions tried. But a solution that attempts to restore confidence may work only if the response is not cautious.



ISSN 0140-8682