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MACROECONOMIC ANALYSIS AND THE DEVELOPING COUNTRIES 1970–1990

Ian M. D. Little

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PREFACE

The International Center for Economic Growth is pleased to publish *Macroeconomic Analysis and the Developing Countries: 1970–1990*, by Dr. Ian M. D. Little, as the forty-first in our series of Occasional Papers, which feature reflections on broad policy issues by noted scholars and policy makers.

In this paper Dr. Little observes that until the 1980s there was a dearth of studies of short- and medium-term macroeconomic policy in the LDCs. This was because the conventional instruments of macroeconomic policy—variations in exchange rates, interest rates, and borrowing practices—had been little used. Countries preferred to use strict controls to maintain external balances, while both internal and external borrowing was severely constrained by a lack of markets.

In the early 1970s, the Bretton Woods system collapsed, and external borrowing became a cheap option, while the oil importers suffered a severe worsening of their terms of trade. The need for, and importance of, sound short- and medium-term macroeconomic policy became paramount, but LDC governments had little or no experience to guide them.

The sudden increase in the availability of credit resulted in a burst of very heavy borrowing partly to offset the effects of the shock, but mainly to promote development by increasing public sector investment. Unfortunately, for various reasons, including the lack of adequate systems for controlling, appraising, and monitoring public projects, much of this investment produced little. It failed to generate the resources needed to service external debt.

The additional shocks of 1979–80 put further strain on the LDCs. Many failed to adjust in time. The rapid rise in debt continued, culminating in the crisis of 1982, after which international credit dried up. Many LDCs were in recession in the early 1980s. The extent of recovery has been quite varied. Those that managed to stimulate exports have fared best.

Throughout his analysis, Dr. Little has attempted to determine which factors—among the many internal, external, exogenous, and policy induced shocks—contributed most to these countries' difficulties, in the hope that similar disasters might be foreseen in the future and appropriate policy might be devised to offset the dangers. Dr. Little's policy recommendations stress firm budgetary control, including care in investment and in managing public debt. He emphasizes that investment must be coordinated so that it does not exceed available funds. He also favors flexible exchange rates.

Dr. Little, along with esteemed economists Richard Cooper, Max Corden, and Sarath Rajapatirana, undertook a project for the World Bank to examine the macroeconomic policies of eighteen diverse developing countries. They set out to analyze the success and failure of these countries in dealing with disturbances, whether internal or external. This paper reports some of their findings, which are published in their entirety in the recent volume *Boom, Crisis and Adjustment* (Little, Cooper, Corden, and Rajapatirana 1993).

We at the International Center for Economic Growth hope that Dr. Little's contribution will help developing countries to avoid past mistakes. Dr. Little brings to his analysis a wealth of experience, ranging from seminal contributions to economic theory to active involvement in welfare economics, public finance, and economic development strategy. His work—and that of his colleagues—represents a vital contribution to our mission to promote reforms that will advance human welfare and help support emerging democracies throughout the world.

Nicolás Ardito-Barletta
General Director
International Center for Economic Growth

March 1993

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ABOUT THE AUTHOR

Dr. Ian M. D. Little is an emeritus fellow of Nuffield College, Oxford University. He has specialized in the economics of developing countries since 1958, when he became a member of the MIT Mission to India. Dr. Little was professor of the economics of underdeveloped countries at Oxford from 1970 to 1975 and vice president of the OECD Development Centre in Paris from 1965 to 1967. He is the author or coauthor of several well-known books on development.

Macroeconomic Analysis and the Developing Countries 1970–1990

Ian M. D. Little

Neglect of the Macroeconomics of Developing Countries

In 1982 I wrote that "the short and medium term macroeconomic management of LDCs was a much neglected subject until very recently, when some work began to appear." "But this is too recent," I added, "and perhaps as yet too tentative, for me to have been able to absorb it" (Little 1982).

The reasons for the neglect are clear. Until the early 1970s, there was little use of the instruments of macroeconomic policy, and little variability in such use as there was. Consider first the handling of balance of payments problems. Exchange rates were fixed, relative to the U.S. dollar, the pound sterling, or the French franc. Of course, there were some devaluations, but they were regarded as measures of last resort. (Notable empirical studies of these measures include Díaz-Alejandro 1965 and Cooper 1971.) These studies showed that "the most exaggerated fears of those opposing devaluation cannot be backed by substantial experience" (Díaz-Alejandro 1971). But policy makers in developing countries preferred to control imports, and almost all development economists endorsed this policy, holding strong a priori views about the inefficiency and even perversity of changes in exchange rates. The consequent protectionism chimed in well with the belief in import substituting industrialization.

The use of reserves and borrowing abroad can also be regarded as instruments for dealing with balance of payments problems. While, of course, these instruments were used, their use was much more constrained than it later became. Reserves were usually kept low, and were not built up when there was a favorable movement in the terms of trade. Holding large reserves was rare and widely regarded as a waste of development potential. Borrowing was, apart from trade credit, mainly concessionary and official, and was limited by the creditor countries. So there was little room for the deliberate use by a developing country of unused borrowing capacity to meet temporary balance of payments difficulties (though in some cases aid was increased for this purpose by donor agencies).

Turning to fiscal policy, we note that financial markets in many LDCs were so underdeveloped that governments could borrow little or nothing from the public. In some, however, deposit-taking banks were forced to buy government paper at low interest rates. It was recognized that this deprived the private sector of funds; but this was not a matter for deep concern where public investment was believed to be most important for development. Thus, budget deficits that could not be financed by foreign borrowing were financed mainly by borrowing from the central bank, and the increase in the quantity of money associated with a given deficit was probably fairly constant. In these circumstances fiscal policy largely consisted of deciding the size of the government deficit that would have to be financed domestically, because this would determine the increase in the quantity of money and inflation. Most countries outside Latin America were monetarist in outlook and fairly restrained in their budgetary policies. In Latin America this restraint was rare, and certain aspects of inflation were much discussed, particularly the question of whether it was an unavoidable concomitant of growth with a supposedly rigid economic structure. But it was not discussed in the context of a general macroeconomic model. Thus, the concept of inflation as a tax was not used, although it had been so christened at least as long ago as 1923.[1]

Monetary policy consisted mainly of controlling interest rates at low levels, thus ensuring an excess demand for credit, which allowed governments to influence or direct the lending of the commercial banks and development finance institutions.

The above sketch, which is not too much of a caricature, shows that the reason for the lack of studies of short- and medium-term macroeconomic policy is largely that there was not much for the economic theorist to analyze. With interest rates and exchange rates (and a good many other prices) controlled, and foreign borrowing exogenously constrained, the complex interactions between the main macroeconomic magnitudes, which are now the diet of macroeconomists, were suppressed. By the same token there was little experience on the part of economic policy makers in how to construct coherent economic policies when there came to be more degrees of freedom.

The biggest change in the economic environment in the early 1970s was the rise in the availability of foreign finance. There was little in the recent development literature in the early 1970s, or even during most of the 1970s, about either the domestic consequences of heavy foreign borrowing, or the prudent limits to such borrowing. History is studded with debt crises, but in the postwar period they were quite rare before the early 1980s. The Pertamina crisis in Indonesia was the most notorious, but this arose from the short-term borrowing of a parastatal enterprise and was atypical. Ghana was the other serious case, but this too involved overborrowing on short-term suppliers' credits. In 1970, no developing country was over the top so far as the ratio of long-term debt to gross domestic product (GDP) was concerned. A few, such as India and Pakistan, had high ratios of debt to exports (around 350 percent) but their borrowing was concessionary, and their debt service was less than 25 percent of exports. There was little awareness or analysis of debt traps—with the exception of Andrzej Krassowski's 1974 study—though it is also true that the state of play excused this neglect.

Other degrees of freedom were then and still are more a matter of choice by government. There were in the 1960s occasional relaxations of those controls over trade or finance that were, as we have seen, typical of the developing world. Almost all of these liberalization attempts were failures, the exceptions being those in Korea, Taiwan, and Singapore; and there followed a reversion to the trade and financial repression model. They were made in the context of balance of payments or inflationary crises without benefit of a coherent macroeconomic plan, and without surrender of the ideology of import substitution or the belief that the government should direct credit.

In *Industry and Trade in Some Developing Countries* (1970), Little, Scitovsky, and Scott (henceforth LSS) provided an analysis, based on studies of six countries, of the iniquities of import substitution and control systems.[2] Their study also contained macroeconomic analysis, especially in chapter 11 (written by M. FG. Scott), which tackled the problem of how best to traverse from a highly protected industrial system, heavily dependent on import controls, to a far less protected system, in which the balance of payments was kept in equilibrium by the traditional methods of fiscal and monetary policy and the exchange rate. The suggested steps were gradual. First, tariffs should replace quotas. Then there would be an initial large devaluation, offset by changes in tariffs and export taxes. These would be gradually reduced in a planned and announced manner to a simple, uniform low tariff. The problems of interest rates and capital movements were mentioned, but not sufficiently analyzed. These latter problems were more fully considered by Mackinnon and Shaw, whose 1973 books mounted as strong an attack on financial repression as LSS had on trade repression. Mackinnon analyzed the Korean liberalization of the 1960s in particular, this perhaps constituting the first macroeconomic analysis of any liberalization process. He mainly criticized the failure to liberalize imports sufficiently, resulting in an excessive buildup of reserves, and hence monetary expansion and inflation.

So far as policy was concerned, these books were widely ignored in the 1970s, except in Chile and Korea. The Chilean liberalization of trade followed the advocacy of LSS quite closely. Perhaps this work was read at Chicago. So far as Korea is concerned, E. S. Shaw was, I believe, very influential in the later 1960s and early 1970s. When I was in Korea in the late 1970s, I asked Kim Jae-Ik, then a high official in the Economic Planning Bureau, about the trend of their policies. He said I had no need to ask him. Pulling LSS down from his shelves, he said "these are the policies we are going to pursue." From about 1973 to 1978, however, Korea had embarked on a drive for heavy industry which could not be said to be in the spirit of LSS (or, for that matter, Shaw or Mackinnon).

But it is probably exceptional for a book or article to be influential in less than a decade. Normally the influence is initially only on students. One has to wait about two decades before they are in power, even in developing countries. The economic presumptions of those in authority in the 1970s had been formed by the development economics of the 1950s and early 1960s. This impressed on them the essential role of the public sector in promoting development, the importance of industrialization through import substitution, and the need for a big push to propel the economic process onto a take-off path. Taken together these factors clearly indicated to them a large rise in public sector investment as soon as borrowing became easy, especially as they would have read little or nothing about the need for prudence in increasing the foreign debt.

The seeds of decontrol might have fallen on less stony ground if it had not been for the new ease of borrowing. This permitted fast growth of gross national product (GNP) for the time being, despite the oil price shock of 1973–1974. There was little incentive to change policies. It seems that disaster, or if not disaster at least a period of stagnation, is usually a necessary condition for successful reform. The borrowing during the years 1973–1982 was disastrous for many countries, although it was accompanied by a rise in investment, mainly public investment, as a proportion of GNP. But bad policies, which the borrowing permitted to continue, resulted in the rise in investment being insufficient to prevent the increasing debt from becoming a crippling burden. A period of reform began in 1983.

A World Bank Project on Macroeconomic Management in Developing Countries

Only about two years after my published remark that macroeconomic management was a neglected subject, and despite the fact that I had paid little attention to macroeconomics since I was in the U.K. Treasury in the mid 1950s, I found myself designing, with the close help of Max Corden, a major research project on that subject on behalf of the World Bank. Carlos Díaz-Alejandro, who in our opinion was an almost indispensable partner in this enterprise, agreed to join. Very sadly, before he could make much contribution, he died. Richard Cooper agreed to replace him. After the usual considerable delay, the World Bank agreed that the project should go forward under the direction of Sarath Rajapatirana, who is also coauthor of the recent synthesis volume *Boom, Crisis and Adjustment: The Macroeconomic Experience of Developing Countries*.

The project was to investigate the macroeconomic policies of seventeen (later eighteen) developing countries from about 1965, to record and analyze their successes and failures in dealing with disturbances, whether internal or external, exogenous or policy induced, and to assess the effects of such short- and medium-term policies on long-run growth.[3] The countries were not selected in any scientific manner. We aimed to include all the major non-centrally planned economies, to have about equal numbers from the continents of Asia, Africa, and Latin America, and to have at least a sprinkling of small countries. Apart from the above criteria, whether or not a country was included often depended on our finding someone we trusted who was keen to do the job. The result was quite a diverse set of countries, whether diversity is measured in terms of politics, population, poverty, or previous history. Together they comprise about 60 percent of the GDP of developing market economies.

Corden (1990, 1993) and Cooper (1992a, 1992b) have independently published what might be called interim reports on this research project, in particular the policy lessons to be learned. Reference should also be made to John Williamson's comment on Corden (1990). In what follows I also draw almost exclusively on this same research project. I hardly disagree with anything that Cooper and Corden have written independently, nor, of course, with the actual concluding chapter of the forthcoming book. But the stress both in the interpretation of the history of the period (1965–1990, but especially 1973–1990) and in the choice of lessons may differ slightly.

The whole period 1973–1990 divides informatively into three periods of boom, crisis, and adjustment, as the title of the book implies. The first period, 1973–1979, in which there was satisfactory growth for most countries, begins with the oil price rises of 1973–1974, and ends with the second oil price shock of 1979. The second period, 1979–1982, is one of rapidly developing crisis, marked by balance of payments problems and heavy borrowing, as well as recessions or stagnation, ending with the debt crisis of 1982. The last period is one of major policy reforms and a recovery of output for most countries: the debt crisis was contained, but debt remained a serious burden. Although the 1980s may be termed a lost decade for most of Africa and some countries of Central and South America, major advances were made by several Asian countries.

A Period of Cheap and Easy Credit: 1973–1979

I guess that some may think that the dominant event of this first period, for the non-oil exporters among developing countries, was the shock of the severe worsening of the terms of trade that the oil price rise caused. Although this was certainly a shock, it did not cause a recession in any of our eighteen countries, at worst a slowing down of growth.[4] During this period three of the countries benefited from the oil price rise, while for five others its importance was overshadowed by the greater importance of the price of coffee, which tripled from 1975 to 1977.[5] But even for these coffee producers the greater ease of borrowing (itself partly caused by the oil price rise) was a major influence, while for the rest (except for India) it was the dominant influence.

Borrowing permitted countries not merely to avoid any temporary fall in consumption that might otherwise have been caused by the adverse movement in the terms of trade, but also to promote public sector investment booms. There was an investment boom between 1973 and 1978 in sixteen of our countries,[6] and in all except Chile and Kenya it was primarily a public sector boom. In most cases the boom began around the time of the oil price shock. In Colombia, Kenya, and Sri Lanka the boom began later, in 1977 or 1978. The rapidity of the rise in investment was sensational in several countries. For instance, Morocco raised the ratio of public investment to GDP from about 5 percent to 21 percent from 1973 to 1977; Côte d'Ivoire from 11 percent to 21 percent from 1974 to 1978; Nigeria from 5 percent to 17 percent from 1974 to 1976; and Sri Lanka from 7 percent to 17 percent from 1977 to 1982.

The ratio of investment to GDP was higher in the period after the oil price shock (1974–1979) than it was before the shock (1970–1973) for all the countries, with the exception of Colombia and Kenya. The average was about 23 percent against 19 percent. This of course was accompanied by a rise in borrowing. The ratio of debt to GNP rose from 1973 to 1979 for all the countries except Pakistan, Korea, India, Colombia, and Nigeria.[7] In no country, however, did debt to GNP exceed 50 percent, exceeding 40 percent only in Côte d'Ivoire, Costa Rica, Pakistan and Morocco. This, combined with the fact that most of the borrowing had apparently been devoted to raising investment rather than consumption, made some influential observers complacent about the level of debt at the end of the 1970s.

It is true that there could not have been a serious debt problem if the investments made had had a good rate of return at border prices, that is, directly or indirectly in terms of foreign currency earned or saved, greater than the rate of interest on the borrowing. Unfortunately, there are good reasons to believe that much of this investment had low or negative rates of return. Few countries if any had an adequate system of control and evaluation of public sector investments. Indeed the extraordinary speed with which public sector investment expenditure rose was hardly compatible with such a system. Sometimes the ministry of finance did not even know what was going on. In other cases, it was powerless in the face of the president's whim, or popular support for some great project that could be plausibly dressed up in nationalistic garb. In some countries, corruption was an expensive dictating factor in both project choice and implementation. On top of all this, the value of any financial constraint was reduced by the price distortions that were so prevalent. Import substitution was still a misguiding light, and could lead to profitable projects with negative returns in terms of foreign exchange. Valid and objective cost-benefit analysis was a rarity. Manuals of cost-benefit analysis for developing countries, available by 1970, can be added to the list of useful books that were widely ignored in the developing world (though influential by the second half of the 1970s among donor or creditor agencies).[8]

The above considerations are independent of a final and more excusable reason why a litter of white elephants was conceived in the 1970s. This is the fact that expectations may be amiss. Prices had become more volatile in the 1970s, making predictions more difficult. And it can be argued that there was no good reason to anticipate the rise in interest rates in 1979 and the recession that followed. Some poor investments can be attributed to this uncertainty. But this does not alter my belief that the public decision-making processes in most developing countries were inadequate to make good use of the huge influx of funds in the 1970s, an influx that continued, as we shall see, until 1982. It must also be noted that the large rise in borrowing from 1979 to 1982 was at interest rates that were known to be high.

Heading for Crisis: 1979–1982

Our second period begins with the terms of trade shock of 1979, the main feature of which was a more than doubling of crude oil prices from about \$15 a barrel to over \$30 a barrel. A secondary feature was the fall in beverage prices after 1977. There was also an interest rate shock at around the same time, with rates rising from the nominal rate of about 6 percent for a three month loan at the London interbank offer rate (LIBOR) to 15 percent by the end of 1979. This raised the cost of servicing the existing debt, which was mostly at variable interest rates. This shock was small, however, compared to that of the oil price.[9] Taking the two effects together over the three years from 1979 to 1981, there was an adverse effect of over 4 percent of GDP for half of our countries. In descending order of the size of the shock, those countries were Côte d'Ivoire, Sri Lanka, Chile, Korea, Thailand, Cameroon, Brazil, Kenya, and Colombia. At the other end of the spectrum, Indonesia and Nigeria gained greatly. The effect on Mexico, by now an oil exporter, was negligible, because a positive terms of trade effect was offset by the rise in interest rates.

In terms of the level of debt and the current balance of payments position, most countries were less well positioned to meet the new shocks than they had been in 1973. However, the position was already seriously threatening for only a few. For instance, Chile, Costa Rica, Côte d'Ivoire, Kenya, and Morocco had reached debt-to-GNP ratios of over 40 percent and also had very large current account deficits, varying from about 6 percent in Chile to about 17 percent in Côte d'Ivoire. In addition, Korea, Sir Lanka, and Thailand had huge current account deficits, although their debt was still moderate. All of these countries, except Costa Rica and Morocco, also suffered seriously from the 1979–1981 shock. As we make clear later, however, neither the initial position in 1979, in terms of indebtedness or the balance of payments, nor the size of the shocks is a good indicator of whether a country ran into a serious debt crisis in 1982, or soon after.

Eight of our countries were in deep trouble by the end of 1982.[10] These were also the "debt-crisis" countries, meaning those whose debt was to be rescheduled in the period 1983–1988. Some, for example, Costa Rica, Mexico, and Nigeria, had already declared a moratorium or were in arrears on commercial debt. But the debt crisis was still in the future for others. So what do we mean by "deep trouble"? We mean a lack of creditworthiness (or adequate reserves) combined with a severe current account deficit. This combination forces either a profound and rapid deflation in order to improve the trade balance, or a default on debt service, or both. The required improvement in the trade balance cannot normally be brought about without causing a recession or deepening an already existing recession. In such a situation, a country will normally request debt rescheduling in order to avoid default, and to reduce the magnitude of the improvement in the trade account that is required.

The ratio of current account deficit to GDP in 1982 was enormous for Chile, Costa Rica, Côte d'Ivoire and Morocco (>10 percent) and very large for Brazil (6 percent) and Nigeria (8 percent). Only Argentina and Mexico had relatively modest deficits (<5 percent). But it was Mexico that ignited the debt crisis with her extremely high debt service ratio—57 percent—caused by a low ratio of trade to GDP and excessive use of short-term debt. The Mexican moratorium caused many other countries to lose creditworthiness and face a need for large reductions of their deficits.

It is no accident that all the debt crisis countries, except for Morocco and Mexico, were already in recession when the urgent need to improve the current account hit them.[11] Because such an improvement

TABLE 1	Estimated Size of Cumulative Exogenous Shocks, 1979–1981 (percentage of GDP)
> 9	Côte d'Ivoire, Sri Lanka, Chile
5–7	Korea, Thailand, Cameroon, Brazil
3–5	Kenya, Colombia, Costa Rica, Morocco
0–3	Turkey, Argentina, Pakistan, India, Mexico
>–10	Indonesia, Nigeria

SOURCE: Little et al. 1993, table 4.2

would deepen and prolong the recession, it is no wonder that they sought rescheduling. Of the other ten countries, which did not reschedule and remained more or less creditworthy, only Indonesia had a slight recession due to bad weather in 1982, and none in 1983.

Obviously the recessions were not initially caused by the withdrawal of foreign credit after 1982, which they preceded. In most cases the recession was caused by the government's measures to combat either inflation or a yawning current account deficit (for example, in Argentina, Brazil, Chile, Costa Rica, and Côte d'Ivoire). Falls in export earnings were also important (for example, in Chile, Côte d'Ivoire, and Nigeria). The withdrawal of foreign credit after 1982, however, prolonged and deepened the recessions. The prerecession annual level of output was exceeded only after three years in Côte d'Ivoire, four years in Costa Rica and Mexico, five years in Brazil, and six in Chile. In Argentina the level of GDP in 1990 was still below that of 1980.

We now revert to the puzzle, already mentioned above, that neither the initial situation in 1979 nor the size of the terms of trade and interest shocks from 1979 to 1981 is a good indicator of whether countries became depressed and sought rescheduling. Table 1 classifies countries by the size of the shock. Table 2 gives our classification of countries under the headings "bad start," "big bad shock," and other attributes. (The definitions of these attributes are given in the notes to the table.) Of the eight debt crisis countries, four—Chile, Costa Rica, Côte d'Ivoire, and Morocco—did have a bad start and a big bad shock. But the other four—Argentina, Brazil, Mexico, and Nigeria—had neither. Of the ten noncrisis countries, four—Kenya, Korea, Sri Lanka, and Thailand—had both a bad start and a big bad shock.

TABLE 2 Determinants of the Crisis of 1979–82 and Growth 1982–89

	Recession 1981–82	Bad start 1979	Big bad shock 1979–81	Policy inaction	Lack of fiscal control	Growth of GNP per capita 1982–89
Debt crisis countries (those rescheduling 1983–88)						
Argentina	1	0	0	1	1	−0.6
Brazil	1	0	1	1	1	2.3
Chile	1	1	1	1	0	4.0
Costa Rica	1	1	0	1	1	2.1
Côte d'Ivoire	1	1	1	1	1	−3.6
Mexico	1	0	0	1	1	−1.0
Morocco	1	1	0	1	0	1.4
Nigeria	1	0	0	1	1	−2.7
						Mean 0.2
Others						
Cameroon	0	0	1	0	0	−1.1
Colombia	0	0	0	1	1	1.7
India	0	0	0	0	0	3.3
Indonesia	1	0	0	0	0	4.1
Kenya	0	1	1	1	1	0.7
Korea	0	1	1	0	0	8.9
Pakistan	0	0	0	0	0	2.8
Sri Lanka	0	1	1	0	0	2.0
Thailand	0	1	1	0	0	5.5
Turkey	0	0	0	0	0	3.1
						Mean 3.1
						Overall Mean 1.8
						Weighted Mean 2.4

NOTE: "Bad start" = current account deficit / GNP > 5.6% in 1979; "big bad shock" = total cumulative negative terms of trade and interest shock, 1979–81 / GNP > 4.3%; for "policy inaction" and "lack of fiscal control," see text.
SOURCES: Little et al. 1993, table 4.4, and World Bank data base.

We are not, of course, suggesting that initial conditions and shocks are irrelevant. But the evidence is that other factors dominated, and overrode their influence. These other factors include the budgetary responses of governments to a deteriorating situation and their handling of the exchange rate. Official lending was also of importance in a few cases (for example, Costa Rica, Kenya, and Sri Lanka).

Table 2 in effect presents a simple analysis of what separates the debt crisis countries from the rest. We have already noticed that the initial state of play and the size of the shock are not accurate discriminants. It is obvious from the table that the best discriminants are "policy inaction" and "lack of fiscal control."[12]

These characteristics need some discussion because it is a matter of judgement as to whether they should be attributed to a country or not. In so doing, we could be accused of taking a peep into the future before deciding. Policy inaction generally means a failure to reduce absorption by fiscal or monetary measures. Large deficits and heavy borrowing were allowed to continue for too long. Our ascriptions are well supported by the country studies, though it should be noted that inaction includes inadequate or very delayed action. Kenya is a borderline case. There was already a serious problem in 1979, but fiscal action was delayed until FY1981–1982. The public deficit, however, was halved from 1980–81 to 1982–83. Chile is a special case in that its inaction lay primarily in its failure to devalue, for Chile was running a public sector surplus. Of course, if no action was required there is no point in recording inaction. But, in fact, all the countries for which a zero is recorded took some deflationary fiscal or monetary action in the period, except possibly Indonesia, which experienced a large favorable shock.

Lack of fiscal control means that the finance ministry was unable to control public expenditure. This was usually because parastatal institutions or state governments could borrow, either from the central bank or abroad, without the permission, and in some cases without the knowledge, of the finance ministry. But it could be because political conditions made the finance ministry too weak to curb other central government ministries. This lack of control is ascribed where there is explicit reference to it in the World Bank project's country studies. The lack of fiscal control was clearly a contributory reason for inadequate

TABLE 3 Average Real Exchange Rates, 1979–1988 (1978 = 100)

	1979	1980	1981	1982	1985	1988
Debt crisis countries						
Argentina	141	184	167	93	81	69
Brazil	85	76	92	97	76	78
Chile	101	117	138	125	80	59
Costa Rica	105	115	73	84	93	69
Côte d'Ivoire	110	112	96	88	81	103
Mexico	106	119	135	97	103	82
Morocco	100	97	89	87	72	65
Nigeria	103	110	122	125	183	33
Others						
Cameroon	99	97	89	87	96	115
Colombia	103	105	113	121	96	61
India	100	111	115	111	110	79
Indonesia	76	82	89	96	74	40
Kenya	97	96	93	96	96	70
Korea	103	100	102	104	91	84
Pakistan	97	98	111	101	93	66
Sri Lanka	108	124	132	140	145	113
Thailand	101	110	113	116	106	85
Turkey	108	84	83	71	66	52

SOURCE: International Monetary Fund.

action in the face of the huge budgetary and current account deficits that were a feature of the early 1980s. It was this prevarication and failure to act that turned a serious situation into a disaster for so many countries.

Another contributory cause was the behavior of the real exchange rate. In all the debt crisis countries, except Morocco, there was an interval of rapid appreciation during the period 1978–1982, though in most countries, appreciation had fallen back by the end of this period (see Table 3). These appreciations were caused by holding on to a fixed rate during the inflationary bubble that occurred after the 1979 terms of trade shock. They were a depressing influence on the tradeable goods sector of the economies, and hence a cause of the recessions that were prevalent in this period. Although several of the noncrisis countries also experienced a significant appreciation of the real exchange rate (Colombia, India, Sri Lanka, and Thailand), only in Sri Lanka was it of the magnitude experienced in Argentina, Brazil, Chile, Mexico, or Nigeria. Sri Lanka was a special case in that the appreciation was caused by a large inflow of concessionary funds after the reforms of 1977, which included a massive devaluation of the currency. There was probably some overvaluation of the currency by 1982, but not enough to result in a recession, especially with the high level of public investment that was maintained.

Reform and Slow Recovery: 1983–1990

A dominant feature of this period was the change in resource flows. An inward flow of resources is measured by the current account deficit plus unrequited transfers (grants of aid and private remittances) minus interest payments on foreign debt.

From 1977 to 1982 all of our countries, except Argentina and Indonesia, relied on an inward transfer. This averaged over 5 percent of GNP in the case of Costa Rica, Morocco, Kenya, Turkey, Sri Lanka, and Pakistan. From 1983 to 1988 only Morocco, Sri Lanka, and Pakistan had similarly large inflows, mainly accounted for by workers' remittances (though aid was also important for Sri Lanka). For many the inflow changed to an outflow. The change was very large (over 7 percent of GNP) for Côte d'Ivoire, Costa Rica, Chile, Mexico, Morocco, and Korea.

The size of the current account deficits in the early 1980s was certainly unsustainable in a number of countries. Reliance on an inflow of resources had to be reduced, whatever the state of the world capital markets. By 1983 the size and speed of the reduction was not a matter of choice. It was forced on countries by a sudden shift in lenders' perceptions of the risks involved. Korea is the outstanding exception, maintaining creditworthiness, but choosing to reduce her debt. Large current account deficits around 1980 were rapidly reduced, and became large surpluses after 1986.

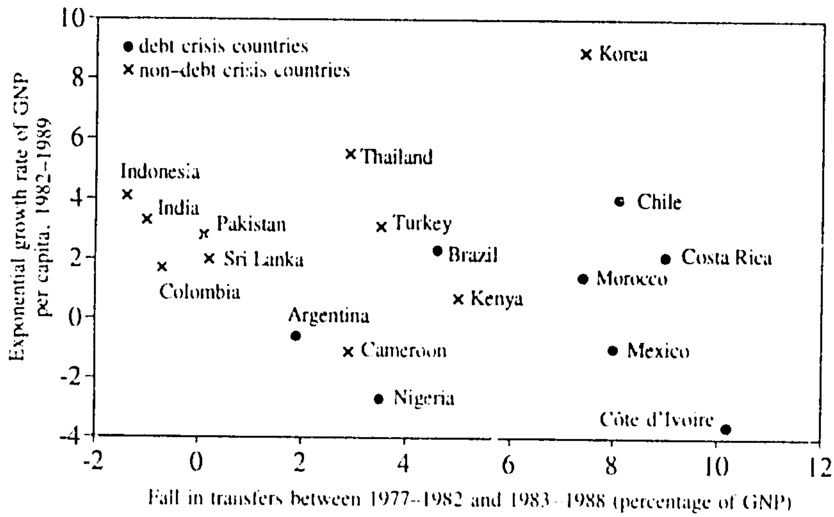
Ten of our countries did continue to benefit from inflows in the 1980s, even if on a much reduced scale. But in five of these cases, the inflow was more than accounted for by remittances or aid (Costa Rica, Morocco, Kenya, Turkey, and Colombia). New borrowing exceeded interest only for India, Indonesia, Pakistan, Sri Lanka, and Thailand—all Asian countries.

We have seen that neither initial conditions of debt and current account deficits in 1979, nor the size of the exogenous shock experienced in the period 1979–1981, was a good indicator of whether or not countries succumbed to recession or became unviably indebted in the next few years. Rather similarly, neither the initial conditions in 1982, nor the shock of the virtual elimination of commercial credit that we have just described, were good indicators of the growth in GNP per capita from 1982 to 1989.

Let us elaborate on the above paradox. Simple regressions were calculated of the growth of GNP per capita on various measures of initial debt, on the current account deficit, as well as on a dummy variable for whether the economy was in recession. Although the coefficients all had the expected signs, none was significant at the 10 percent level. The statistical insignificance of debt may surprise readers. It can be explained by a few outliers. Costa Rica had a huge debt, but grew faster than the mean rate. Korea was quite highly indebted, but grew famously. Nigeria had negligible debt, but its GNP per capita fell faster than that of any other country except Côte d'Ivoire. This does not show that debt was irrelevant; high debt surely handicapped growth. What it perhaps shows is that cross-country regressions are of questionable value, especially when countries as fundamentally different as Korea and Nigeria are included.

But what about the change in transfers? The eight debt crisis countries suffered the largest falls in inward transfers. On average, the change was -6.6 percent of GNP, comparing (as before) 1983–1988 with 1977–1982. For the other ten the average change was -1.9 percent of GNP. So there was a strong association of debt crisis, that is, rescheduling, with the change in transfers. The debt crisis countries also grew much more slowly in GNP per capita from 1982 to 1989. Four of them suffered a fall—namely, Argentina, Côte d'Ivoire, Mexico, and Nigeria—and the (unweighted) average growth rate was 0.2 percent per annum. The average growth rate for the others was a satisfactory 3.1 percent per annum (see Table 2).

FIGURE 1: Growth and the Change in Transfers



SOURCES: Exponential growth rate of GNP per capita from Table 2; fall in transfers from Little et al. table 5.1.

But despite the strong association of debt crisis with both low growth and a large fall in inward transfers, there was no significant correlation between the latter two, as Figure 1 illustrates. The debt crisis countries are marked with naughts, and the rest with crosses. With the exception of Cameroon and Kenya, the naughts and the crosses form distinct groups.[13] The naughts tend to correspond to low growth and a large fall in transfers, and vice versa for the crosses. Regressing growth on the change in transfers and a dummy variable for rescheduling showed the latter to be significant. One might have expected a close relationship between the fall in transfers and growth, via investment. Thus

Fall in inward transfers → Fall investment →
Low ratio of investment to GN → Low growth

Of the three links in the chain the second and third were elastic ($R^2 \cong .50$), but the first was virtually nonexistent ($R^2 = .14$), as was the simple correlation between the change in transfers and growth. Thus the significant positive relationship between falls in investment and growth is not a satisfactory explanation of the relationship between the debt crisis and low growth. It seems likely that other factors were responsible both for falls in investment and for low growth, rather than that the falls in investment were the cause of low growth.

This suggests the following interpretation. The fall in inward transfers resulted in reduced growth only when the country found itself as a result in severe balance of payments difficulties. Such difficulties are indicated by rescheduling (or payments arrears), which was the only means of moderating the need to improve the trade balance. The balance of trade could not be improved sufficiently in the short run (despite rescheduling) without a reduced level of activity in general, and a reduced level of investment in particular. Only thus could a sufficient reduction in the import bill be achieved. Cuts in public investment were an instrument, while falls in private investment would also result from greater uncertainty and a lower expectation of growth, and in some cases also from a rise in interest rates and increasingly severe import controls.

The core of our analysis of the aftermath of the debt crisis thus lies in the varying need to take deflationary action to improve the trade balance. We would therefore expect a strong positive correlation between exports receipts and growth. This expectation is not disappointed. We have already seen that simple correlations between growth in GNP per capita during 1982–1989 on the one hand, and on the other hand initial conditions of debt, the current account balance and the change in average transfers between 1977–1982 and 1983–1988 were insignificant. But the average ratio of investment is significant (R^2 = .45) and so also is the growth in the value of exports (R^2 = .52). Together these explain 63 percent of the variance as in the equation

$$G = -4.4 + .22\ \mathrm{INV} + .19\ \mathrm{GVALEX}$$

$$\begin{aligned} R^2 &= .63 \\ F &= 13.00 \\ DW &= 2.50 \end{aligned}$$

Where G = Exponential growth rate of GNP per capita, 1982–1989
INV = Average ratio of investment to GNP, 1983–1988

GVALEX = Exponential growth rate of the fob value of imports into industrialized countries 1982–1988, UN sources (this is believed to be a more reliable indication of export success than one derived from the export statistics of the developing countries).

Rising export receipts might be a matter of luck (for example, improved terms of trade), or might result from changes in trade policies, variables that we have thus far neglected.

Changes in the terms of trade were minor until early 1986 when the price of oil collapsed. Coffee, tea, and cocoa prices were also weak. Cameroon, Colombia, Côte d'Ivoire, Indonesia, Mexico, and Nigeria were adversely affected. All of these, except Colombia and Indonesia, experienced recessions. Those most dependent on oil imports, for example, Brazil and Chile, gained. However, the very wide variance of the growth rate of the dollar value of exports (with a range from −12.0 percent per annum in Nigeria to 21 percent per annum in Korea) closely matches that of the growth rate of the volume of exports. The main exceptions were some of the oil producers. Thus Nigeria's large fall in value was accompanied by a (small) rise in volume. Indonesia and Cameroon also experienced a fall in value despite a rise in volume. Chile was luckier; a small rise in volume translated into a large rise in value as the price of copper rose.

To what extent was the varying success with export volume a consequence of changing trade policies? A feature of the 1980s was a more flexible use of nominal exchange rates. Most countries for most of the time managed the exchange rate with a view to making exports more competitive, and keeping them competitive. They were successful in bringing about depreciation of the real exchange rate, which is a measure of competitiveness (see Table 3). For all countries, except Cameroon and Côte d'Ivoire, whose currencies were pegged to the French franc, there was an important real depreciation over the period 1982–1988. The mean depreciation was about 25 percent. This shows that substantial real depreciations could be and were brought about by nominal changes in the exchange rate: In other words nominal devaluation was not immediately or very quickly offset by increased inflation. Ignoring the two near hyperinflation countries, figures for which would distort the averages, and also the two franc zone countries that experienced a rise in the real exchange rate, the mean inflation rate for the other fourteen was 21 percent in 1982, 26 percent in 1988, and 18 percent in 1990.

There is no correlation between the extent of the depreciation from 1982 to 1988 and the rate of growth of total export volume. This was hardly to be expected in view inter alia of the widely different commodity composition of exports (oil and coffee volumes were not responsive to price for institutional reasons), the varying extent of the initial overvaluation of the currency, and the fact that the main depreciation came only toward the end of the period in a number of cases. Manufactures may be expected to be the most responsive to changes in exchange rates, and there was indeed a significant correlation between the growth rate of imports of manufactures by the industrialized countries in the period 1986–1989 and the size of the depreciation in the period 1985–1988. In several countries the growth of manufactured and other nontraditional exports was a major factor in their successful recovery in the 1980s. From 1986 to 1989 the growth rate of the value of manufactured imports into industrialized countries from the world as a whole was 14 percent, and 20 percent from developing countries. The star performers among our countries, with growth rates of over 30 percent per annum, were Chile, Indonesia, Thailand, and Turkey. In all of these there was a real depreciation of 20 percent or more. There can be little doubt but that the conversion of most developing countries to flexible exchange rates was a necessary element in recovery. Cameroon and Côte d'Ivoire have suffered grievously in recent years from their adherence to a fixed rate relative to the French franc.

The oil exporters suffered a new shock in 1986. All except Colombia (a new fuel exporter) suffered large losses of export income from oil. As a result, Cameroon, Nigeria, and Mexico fell into recession in 1986 or 1987 (Cameroon's recession later deepened, and she joined the ranks of the debt crisis countries). Colombia escaped partly by luck (new oil discoveries), but also because of a surge in coal and manufactured exports (the real exchange rate fell by 36 percent). Indonesia also escaped recession, and indeed grew rapidly from 1985 to 1990 (by over 6 percent per annum) despite a 23 percent fall in the dollar value of exports in 1986. She devalued by 45 percent in 1986, took other export promotion measures, and liberalized imports. The result was a quadrupling of manufactured exports from 1985 to 1989, which completely offset the fall in oil export revenues. A comparison with Mexico is interesting. Mexico suffered a similar loss of export revenue in 1986, but also achieved similar success with non-oil exports from 1985 to 1989. However, Mexico had to combat 100 percent inflation in 1986, after suffering a major earthquake in December of 1985. Unlike Indonesia she had lost creditworthiness and suffered from capital flight. Debt service was a larger burden, and she could not run large current account deficits as did Indonesia. Investment cuts and slow growth were required to reduce imports, despite the export successes.

Much has been written about the merits of a trading policy that is unbiased against exports. Comparative advantage has at last ceased to be ridiculed as it was until about fifteen years ago. On top of the simple static efficiency benefits, a good many dynamic advantages have been discerned. Keeping production in line with comparative advantage yields both higher social profits (and hence national savings), and greater equality in most countries. A more open and high trading economy generally permits a faster absorption of technology as well as the ability to borrow more abroad without the danger of a debt crisis. Although I am convinced of the validity of these and other supporting arguments (and have been for about twenty-five years), the present contention that successful growth in the 1980s, and recovery from the 1982 crisis, was largely dependent on export growth (itself largely dependent on a reform of trading policies and more flexible exchange rates) is quite different. Rapid export growth reduced the need for recession, or reduced activity, to restrain imports to a level that could be financed.

Other Features of Boom, Crisis, and Adjustment

The above mainly historical account does not do justice to much of the forthcoming book—in particular, those parts to which my colleagues devoted the most attention.

I have scarcely mentioned the problem of inflation. But its causes, effects, and cures are discussed at length in two chapters that distinguish moderate chronic inflation from very high inflation and the stabilization attempts that the latter demands. Two chapters are also devoted to trade policies, both the exchange rate regime and controls over capital movements and imports.

My own analysis in this paper has run in terms mainly of current account deficits and international borrowing and debt. Deflationary action through fiscal and monetary policy was mentioned en passant. But, of course, current account deficits are usually matched by budgetary deficits; and we saw that inaction on the fiscal front was the main reason why nearly half our countries ran into deep trouble in the early 1980s. The countries' fiscal and monetary policies, and some of the political economy reasons for their differences, are discussed in two further chapters. Finally, there is a chapter discussing the relationship between short- and medium-run macroeconomic policy and long-run growth.

Some Conclusions and Policy Advice

The following conclusions are not fully supported by this particular paper, but are, I believe, supported by the research described. Readers can verify this only by reading the full published results, especially Little, Cooper, Corden, and Rajapatirana (1993).

Firm central budgetary control, meaning control of the access of all public spending agencies to loan finance, domestic or foreign, is essential. Public sector deficits should be planned with an eye on the long-run consequences for the public debt, both internal and external, and the cost of servicing it. Provided only that debt has not already become excessive, deficit finance may be used to help stabilize the real nonagricultural economy in the face of exogenous fluctuations (surpluses may be in order if the private sector becomes unduly euphoric, which can happen). But adaptation to adverse exogenous events must not be delayed for long if no reversal is in sight. Current account deficits and debt can be built up rapidly and lead to a loss of creditworthiness, which forces a much more disruptive adaptation than if policy response had not been delayed.

Public investment must be coordinated to avoid the common situation whereby decentralized agencies embark on projects that together will require more public investment than is likely to be financially possible in the future. Further to this, all large projects should be subject to a system of agreed cost-benefit analysis, and serious heed should be paid to its findings. Windfalls arising from favorable changes in the terms of trade or mineral finds should not be allowed to result in an immediate investment boom. Even if the favorable change is expected to last, sudden rises in expenditure are unlikely to be efficient in achieving their objectives. If the favorable change does not last, rises in expenditure are difficult to reverse. Increases in reserves, invested abroad, can later be used whether the favorable circumstances continue or are reversed.

The exchange rate regime cannot be considered independently of inflation. It is obvious that an economy that is inflating at a significantly higher rate than its trading partners must devalue from time to time, or almost continuously, if it is to enjoy the full (and major) benefits of trade. An overvalued exchange rate necessitates the repression of imports by controls, a highly inflexible and inefficient method of balancing a country's foreign accounts. I believe that a flexible exchange rate is better than intermittent devaluations, which often get delayed and hence lead to undesirable overvaluation and recession, and to adverse speculation and destabilizing uncertainty. Not devaluing frequently when inflation is high amounts to an attempt to control inflation by fixing a price. This may or may not be part of a package of decrees that make rises in other prices, and wages, illegal. In certain (rare) circumstances a brief resort to such price controls may be helpful; such as where the expectation of inflation has become embedded and needs to be broken as part of a drive to stop inflation, or reduce it to very low levels. But the emphasis must be on "brief," because the inefficiencies that result if inflation is not in fact stopped rapidly become intolerable. A corollary is that a fixed rate of exchange should not be maintained for fear of inflation: A devaluation is an essential adjustment to inflation, not a cause of it.

Inflation presents the authorities with many problems. It also has many disadvantages for private persons and institutions. It has only one, albeit important, countervailing merit. It permits the authorities to spend without taxing. Where taxing is very difficult for institutional or political reasons, this may be a social advantage. But there are grave dangers. The disadvantages of inflation lead to indexing, which reduces its value for the authorities. For this and other reasons the rate of inflation tends to accelerate. When inflation becomes very high, action has to be taken. Both it and its cure become very costly in economic and social terms. I believe that the authorities should become alarmed if inflation rises to 10 percent or more. The long-run control of inflation must lie with fiscal and monetary conservatism. But if the cause is a supply side shock, such as a blip in world prices, a revaluation of the currency may be more appropriate than any deflationary, monetary or fiscal, action. If the prime cause of a price rise is a harvest failure, deflationary action may also be inappropriate. Prices will stop rising and may fall as agricultural output recovers

Finally, our research suggests that stability of growth, and especially stability of the investment ratio, is good for growth. This may not be quite as obvious as it sounds, for one has often heard the suggestion that living dangerously by boom and bust may be better than steady progress. While the average level of investment over the years was positively significant, a simple cross-country correlation explained only 29 percent of the variance of growth in income per capita from 1970 to 1989. The apparent productivity of investment (the growth rate of income per capita divided by the investment ratio) varied enormously, from over 20 percent to less than zero. What determines the efficiency of investment is still a neglected subject.

NOTES

1. A subheading of chapter 2 of Keynes 1923 reads "inflation as a method of taxation." Personally, I have some misgivings about the term "inflation tax." Although inflation resembles a tax, in that it raises resources for the government, its rate is more of an accident than a deliberate imposition. It is only in some models that the government chooses the rate of inflation. At the time of writing, Keynes thought that there was a good deal to be said for the inflation tax if it was kept low. Cooper tends to agree with Keynes (see Cooper 1991).

2. This whole project of the OECD Development Centre seems also to have been a model for the four much larger comparative studies initiated by the World Bank in the 1980s. The country studies that were published by Oxford University Press were Brazil by Joel Bergsman, India by Jagdish Bhagwati and Padma Desai, Mexico by Timothy King, Pakistan by Stephen Lewis, the Philippines by Gerardo Sicat, and Taiwan by Mohuan Hsing.

3. The seventeen countries were Argentina, Brazil, Cameroon, Chile, Colombia, Costa Rica, Côte d'Ivoire, India, Indonesia, Kenya, Mexico, Morocco, Nigeria, Pakistan, Sri Lanka, Thailand, and Turkey. Country studies were commissioned for all of these, usually with two authors involved. It is hoped that many of these book-length studies will be published. No country study was commissioned for Korea, but it was added because Cooper was already engaged in a Korean study and was familiar with the economy.

4. Chile had a major recession in 1975. But this was only very partially and indirectly a result of the oil price rise.

5. Indonesia and Nigeria benefited initially, and Mexico later. Cameroon benefited only at the very end of the period. Morocco gained in 1974 from a phosphate boom.

6. Brazil and India are the exceptions.

7. The debt figures quoted include long- and medium-term public and publicly guaranteed debt but exclude short-term debt (less than one year), for figures that are not available for this period.

8. See Little and Mirrlees 1990.

9. The increase in interest paid from 1979 to 1982 was large for several countries—notably Argentina, Chile, Côte d'Ivoire and Mexico—but most of this increase was due to debt incurred within the period at the new high interest rates.

10. Argentina, Brazil, Chile, Costa Rica, Côte d'Ivoire, Mexico, Morocco, and Nigeria.

11. By "recession" we mean a fall in annual GDP (quarterly figures are not available), with recession continuing until GDP recovers to the level of the year preceding the fall.

12. It is equally obvious that "Continent" discriminates well. There are, for example, no Asian countries in the crisis list. Unfortunately we have no very convincing explanation of why the Asian countries handled their economies more prudently and more successfully.

13. It would have been neater if Kenya had asked for her quite heavy debt to be rescheduled. That she did not was probably because of a high proportion of official debt. Cameroon also became a debt crisis country in 1989, but this was the result of the oil shock of 1986, not those of 1979–1982.

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