0401

SM/87/269

November 17, 1987

To: Members of the Executive Board

From: The Secretary

Subject: Growth-Oriented Adjustment - Themes from the World Bank-IMF Symposium

There is attached for the information of the Executive Directors a paper on some themes from the World Bank-IMF symposium on growth-oriented adjustment. This paper provides background material for the forthcoming discussion on Wednesday, December 16, 1987 of the papers on issues in the design of growth exercises (SM/87/267, 11/17/87) and on the financial programming and growth exercises (SM/87/268, 11/17/87).

Mr. Goldstein (ext. 7678) or Mr. Khan (ext. 4518) is available to answer technical or factual questions relating to this paper.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

Growth-Oriented Adjustment: Themes from the World Bank-IMF Symposium

Prepared by the Research Department

Approved by Jacob A. Frenkel

November 16, 1987

Earlier this year, the Fund and the World Bank jointly organized a symposium on the meaning and policy implications of growth-oriented adjustment. A brief report on the symposium was circulated to Executive Directors on May 26, 1987 (Secretary's Circular No. 87/55), and the volume presenting the proceedings of the symposium has recently been published. The Executive Board is scheduled to discuss certain issues in the design of growth-oriented adjustment programs on December 16, 1987. A paper entitled "Issues in the Design of Growth Exercises" has been prepared by the staff, and a more technical companion paper, "Financial Programming and Growth Exercises," has also been issued for Executive Board discussion.

To provide additional background for the forthcoming discussion, it may be useful to try to identify some major themes or issues that recurred during the February symposium.

1. The quality of adjustment

In considering the relationship between adjustment and growth, participants were in general agreement that it was necessary to reject two equally simplistic propositions--that there is an inherent conflict between adjustment and growth, and that growth follows automatically from adjustment. Experience is not consistent with the notion that by avoiding adjustment--and living with high inflation, large budget deficits, overvalued real exchange rates, unrealistic interest rates, and heavy external debt--a country can purchase good growth performance; nor does experience support the view that any kind of adjustment--even one characterized by excessive cuts in imports and in productive investments, and carried out against a backdrop of depleted reserves and creditworthiness--can lay the proper foundation for future growth.

Instead, it was stressed that the key to combining effective adjustment with durable growth lies in a quality of adjustment that emphasizes increases in exports, saving, and economic efficiency and that allows high-quality investment projects to survive. But this kind of adjustment

must be managed by a judicious combination of demand management, relative price, and structural supply-side policies that: (a) establish an environment of overall financial stability; (b) put in place--and allow economic agents to respond to--appropriate incentives for exporting, saving, and the adoption of cost-saving techniques; and (c) encourage essential changes in the structure of an economy that will increase the production of tradables in order to maintain growth and balance-of-payments viability in the medium term.

2. The international environment

Symposium participants agreed that the prospects for success of growth-oriented adjustment programs do not rest exclusively with the quality of program design and implementation. The international trade and financial environment is also a major conditioning factor. Indeed, one of the main reasons why many developing countries have found it so difficult over the past five years to combine adjustment with growth is that the external environment was often an inhospitable one. Historically weak primary commodity prices, declines in developing-country terms of trade, relatively slow growth of export markets, resurgent protectionist measures abroad, and sharp swings in key-currency exchange rates--each took their toll and worked against the beneficial effects of declines in nominal international interest rates.

It was emphasized that industrial countries--because of the substantial spillover effects of their monetary, fiscal, and commercial policies on the world economy--need to be full partners in growth-oriented adjustment. They can make a valuable contribution by pursuing policies that are compatible with healthy, noninflationary growth of world demand, lower international interest rates, and an appropriate pattern of exchange rates; by rolling back protectionist measures; and by ensuring that official export credit and official development assistance are maintained at adequate levels.

3. The importance of external financing during the adjustment process

Several participants pointed out that a notable characteristic of successful growth-oriented adjustment cases has been the supportive role played by external finance. Such financing has not only provided a protective cushion against speculative pressures while the authorities have demonstrated the extent of their commitment to adjustment, but it also has helped to sustain imports and investment while longer-term structural policies have been put in place. By the same token, the sharp decline in net private lending to indebted developing countries that took place between 1981 and 1983 was regarded as a significant contributory factor to the large cuts in imports and investment that followed in its wake. Lack of support and understanding from creditors put the structural changes necessary for durable growth at risk. As such, the fall-off in net new lending by commercial banks to developing countries is cause for serious concern.

Two caveats about financing were also emphasized. One is that the greater financing needs and longer maturities associated with structural policies should not be used simply to delay adjustment. In other words, adjustment and financing should not be treated as substitutes by the borrowing countries. The second is that foreign savings must be used efficiently to build a productive base that will permit the additional external indebtedness to be serviced on a sustainable basis.

4. The necessity of the case-by-case approach

There was general agreement that there is no alternative to designing growth-oriented adjustment programs on a country-specific, case-by-case basis. The structure of goods, labor, and financial markets; relations with creditors; the stage of development; and political sensitivities are simply too different across developing countries to permit homogenized policy packages to work well. Although the need for growth is pressing in both the middle-income countries of Latin America and in the low-income countries of sub-Saharan Africa, and although both groups are struggling under a heavy burden of external debt, the nature of their problems is not the same; nor can the solutions to those problems be derived without regard to the state of human capital, the degree of export diversification, the mix between commercial and concessional finance, or the size of internal markets.

Similarly, many participants stressed that there is no substitute in the process of implementing growth-oriented adjustment programs for the continued commitment and support of governments and public opinion. This is especially so when far-reaching structural reforms are being introduced and/or when deeply-entrenched inflationary expectations--and the institutional devices that have grown up around them--are finally being confronted.

5. Lessons from long-run growth patterns

In setting the objectives of a growth-oriented adjustment program, several authors and discussants indicated the advisability of recalling some of the lessons of longer-run growth experience. One is that, over very long periods of time (say, a century), a high growth rate of aggregate GNP is about 4 percent a year. Numbers much higher than that are not in the realm of modern experience. A second lesson is that small differences in growth rates--say, one-half percent a year--amount to very large differences in the levels of GNP over the long term. This property of the powers of compound interest suggests that measures that ultimately may improve growth by tenths of a percent are well worth serious evaluation. The third lesson is that, although the evidence shows that developing countries with a higher ratio of investment to income also tend to have higher average growth rates, one should not overestimate the potential contribution of capital accumulation to growth. According to existing econometric evidence for groups of developing countries, a 10 percentage point increase in the share of investment in GDP might be expected to raise the growth rate 1-2 percentage points.

6. Trade strategy

The development and maintenance of a strong export sector was considered to be one of the cornerstones of a growth-oriented adjustment strategy--all the more so when the country has a large stock of external debt. In this connection, frequent mention was made of the contrast since the onset of the debt crisis, between the strong economic performance of East Asian debtors and the weaker performance of their Latin American counterparts. Although many factors are involved, attention was drawn to the fact that East Asian debtors as a group have had a stronger and more diversified export base that has enabled them both to service external debt and to sustain growth. Latin America's relatively low degree of export openness and its heavy dependence on primary commodities were viewed as liabilities.

In considering how a strong export sector should be developed and maintained, participants arrived at consensus on two points. One is that exports cannot be expected to thrive unless exporting is reasonably profitable in relation to other activities in the economy. The second was that avoidance of an overvalued real exchange rate is the hallmark of successful long-term export performance.

Beyond this, there was much less agreement on overall trade strategy for growth--in particular, on the role of the state in that strategy. Some participants pointed out that the successful export performance of some East Asian countries could hardly be classified as lessons in laissez-faire economics or trade liberalization (in the sense of simply removing any bias in favor of the home market relative to exports). Instead, the East Asian experience can be better regarded as a case study in export promotion and of successful government intervention. Others, more inclined to the merits of the liberalization strategy, noted that attempts to promote exports via export subsidies can violate trade agreements and trigger retaliation, can promote unproductive rent-seeking activity, and might still leave a wide variance in rates of protection across different traded-goods industries. Participants also questioned whether the efficient state mechanisms of some East Asian countries can easily be replicated in other developing countries. Proponents of trade liberalization also argued that liberalization offers benefits for economic growth beyond good export performance, including an increase in competition and the removal of shelters for technical inefficiency.

A review of trade liberalization experience suggested a number of guidelines relevant to the design of growth-oriented adjustment programs. First, liberalization of domestic markets should in general precede the liberalization of trade, so as to give the right price signals for the reallocation of resources. Second, the liberalization of trade should precede--and by a good margin--the liberalization of capital flows, since the latter can produce a sharp real appreciation and destabilize the exportable is sector, since asset markets adjust much faster than goods markets. Third, macroeconomic stabilization should take place at the

beginning of any liberalization program, thus to ensure the needed overall financial stability and an appropriate real exchange rate. Finally, protectionism in industrial countries can limit--but not eliminate--the benefits that developing countries obtain from trade liberalization.

7. Agricultural policies

Given that most low-income developing countries depend on the agricultural sector for the bulk of export earnings and employment and for a sizable portion of their GDP, symposium participants stressed that appropriate agricultural policies are a key element of a growth-oriented adjustment program. Unfortunately, agricultural policies have all too frequently worked against improving efficiency and growth. This result has arisen, inter alia, from: relatively low investment in the agricultural sector; relatively high taxation of the rural sector (via low producer prices for farm products, import substitution for farm supplies, overvalued exchange rates, and protection for manufactured goods); and allocation of agricultural subsidies to large, politically powerful farmers. It was felt that reversing this process could generate large dividends. Particular attention needs to be given to promoting near equality of returns between the agricultural and nonagricultural sectors; to using relative international prices--averaged over, say, a 3-5 year period--as a rough guideline for relative farm and producer prices; and to ensuring that the rural sector receives equitable treatment in the provision of education, infrastructure, and subsidies. In all of this, due regard needs to be paid to the individual country's macroeconomic program and to its particular structure of agricultural production. Again, program design and implementation have to proceed on a case-by-case basis.

8. Fiscal policy and efficiency in the public sector

Prudent fiscal policy and structural reforms aimed to improve efficiency in the public sector were also viewed as having an integral part to play in growth-oriented adjustment programs. Three points were often emphasized. First, in cases where the budget deficit needs to be reduced as part of the stabilization effort, it is important that cuts in government expenditure be selective in order to protect the needy. Put in other words, the budget deficit needed to be cut, but it is also important how it is to be cut (i.e., though tax increases or reductions in expenditures). Second, action against very large budget deficits is basic to any successful anti-inflationary strategy. As long as governments are in deep deficit, they will find it hard to resist the temptation to raise revenue by printing money, with predictable consequences for inflation. Incomes policies, such as those employed in several recent so-called heterodox stabilization packages, can be a useful vehicle for dealing with "inertial" inflation--but they can only be effective when supported by getting the fundamentals "right," including the extension of control over the government budget. Third, there is considerable scope

in much of the developing world for rationalizing public sector investment programs and for improving the management of public enterprises (including, in some cases, divestiture of public holdings).

9. Foreign savings

It was suggested that efforts to mobilize additional foreign savings--and to make more efficient use of them in support of growth-oriented adjustment--should proceed along a broad front and should take advantage of the adaptability of international financial markets. Four aspects of that effort merited high priority. First, a way needs to be found to induce banks to resume new net lending at a reasonable pace to those debtor countries undertaking strong adjustment programs. In this regard, participants from the private banking sector appealed for greater "texture" in future financing packages, by which they meant greater opportunities for on-lending, for debt-equity swaps, and for conversion of existing debt into long-term investments with an up-side as well as down-side risk. Second, debtor countries need to re-examine attitudes and regulations concerning foreign direct investment, with a view to tapping more fully the potential of such investment. Third, improved coordination among donors and greater emphasis on structural reforms should make it possible to obtain better results from a given volume of official finance. A more efficient delivery system for official flows is vital in a situation where such flows account for a large share of total capital flows to developing countries. Finally, there is a need to involve new actors and new financial instruments with appropriate risk-bearing characteristics in the action.

10. Adjustment and the problems of heavily indebted countries

The implications of the debt problem for the achievement of growth-oriented adjustment were repeatedly contested during the symposium. Some participants felt that the large existing stock of external debt--and the difference between contractual and market valuation on that debt--constitute a major obstacle in debtor countries to increased investment, saving, and economic efficiency. Investment was said to be depressed by the lack of new international lending (itself retarded by the market discount on existing loans) and by the risk of increased taxation or inflationary financing of the government financing gap. Stimulating private savings becomes more difficult in the presence of capital flight, which itself is exacerbated by the higher expropriation and default risks associated with a large debt overhang. The argument proceeds as follows. As capital moves out of a country, the domestic tax base shrinks, generating an increase in expected tax rates and, therefore, new incentives for capital flight. Investment in the export sector that would increase the efficiency of that sector likely to be discouraged by the expectation that a large portion of export receipts will need to be devoted to debt

service. Required exchange rate adjustments become more problematic because real depreciation increases the cost, in domestic-currency terms, of servicing foreign debt. Finally, the political will to persevere in adjustment efforts is likely to be sapped by adverse, uncontrollable movements in international interest rates and in primary commodity prices which can more than cancel out domestic sacrifices. That Latin America's interest payments on foreign debt amounted to over 5 percent of its GDP--despite the fall in interest rates and adjustment efforts since 1982--was viewed as a classic case in point. For all these reasons, some participants saw some degree of debt forgiveness as an unavoidable part of any growth-oriented adjustment program.

Other participants, however, while acknowledging the serious problem created by the stock of foreign indebtedness and its market valuation, felt that debt forgiveness need not--and should not--be part of a growth-oriented adjustment strategy. They stressed: (a) the significant achieve ments of the current international debt strategy; (b) the positive effects that sound macroeconomic and structural policies in debtor countries can have on the flow of new money, repatriation of flight capital, and the market evaluation of the existing loans; (c) the serious consequences of unilateral default for ciuntry's future access to international capital markets; and (d) the plausibility of steadily improving debt indicators under a concerted approach to the debt strategy.