

COMMITTEE FOR DEVELOPMENT PLANNING

REPORT ON THE TWENTY-SECOND SESSION

(New York, 19-22 March 1986)

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INTRODUCTION

1. The focus of the work of the Committee for Development Planning at its twenty-second session was the capital requirements of developing countries. The Committee's emphasis on the crucial role of multilateral co-operation in restoring flows of finance to developing countries gives the present report both current relevance and continuity with its previous report, The Challenge to Multilateralism: A Time for Renewal. 1/ Current discussions on the resource needs and lending programmes of multilateral development institutions add to the report's timeliness.
2. The Committee, in the present report, highlights the problems facing development finance and calls for a co-operative solution towards which developed and developing countries, multilateral financial institutions and private financial agencies each have contributions to make. Section E of chapter II of the report, entitled "Towards a co-operative solution", contains the Committee's recommendations and commands the full support of all participating members of the Committee. Other sections of the report provide analysis and background information. While they command a broad consensus within the Committee, they do not necessarily commit all members to every matter of detail. The projections of capital requirements are based on work done for the Committee by Professor Albert Fishlow of the University of California. At the request of the Committee, the technical paper by Professor Fishlow is being published separately by the Secretariat in the forthcoming issue of the Journal of Development Planning (No. 17).
3. As is customary, a section of the report (chap. III) is devoted to the world economic situation. It is based on material provided by the Secretariat.

I. MAIN FINDINGS AND RECOMMENDATIONS

4. Until the flow of development finance is restored, prospects for adequate growth and social progress in many of the world's poorest nations will remain negligible, whatever efforts their Governments make to put their own house in order.

5. During the past few months, there have been some welcome signs of new international leadership, particularly in the initiative put forward by the United States Secretary of the Treasury in Seoul. But, in order to overcome the crisis of development finance, a bolder plan will be needed and one on a truly global scale.

6. The Committee proposes such a plan. Co-operative and mutually reinforcing actions by the multilateral financial institutions, the Governments of developing and industrialized countries and the commercial banks, could together double the flow of finance for development by the end of the decade.

7. This may appear an ambitious target, but it is simply realistic. The Committee's analysis of capital requirements (see chap. II, sect. C below) indicates that, on top of the approximately \$US 40 billion which is flowing already, no more than \$4 billion in new foreign investment and an extra \$2 billion in official transfers can be reasonably projected for the end of the decade, on the basis of present policies. An additional \$25 billion per year will be needed as the minimum necessary condition for restoring moderate, sustained growth in the developing world.

8. The Committee believes that alternative projections which take inadequate financial flows as given and then assume that developing countries will continue to "adjust" to these constraints, are far less realistic - in both political and economic terms. Lowered expectations cannot serve indefinitely as the equilibrating mechanism between the social needs and the financial pressures in the developing world.

* * *

9. The Committee's proposals, which are set forth in detail in chapter II, section E below, seek to enhance the quality, as well as the quantity, of development finance.

10. Industrialized countries must promote an international economic environment with lower interest rates, sustained moderate growth and a dynamic receptiveness to developing country imports. They must increase bilateral assistance to the poorest countries, including the wider adoption of debt relief and support for export credit, and improve the quality and co-ordination of their aid programmes. They must also provide the moderate amounts of resources required for an expansion of the multilateral financial institutions, as detailed below.

11. Multilateral institutions, particularly the World Bank, must rise far more vigorously to the challenge. They must again become the primary source of international development finance. Of the \$25 billion in new lending required annually, \$8 billion must come from the World Bank and the regional development banks, and \$4 billion from the International Development Association (IDA) and other concessional assistance.

12. The needed expansion in World Bank lending, which would double net annual disbursements by 1990, could be accomplished with essentially no cost to taxpayers in the industrialized world by increasing the World Bank's gearing ratio or expanding its callable capital.

13. Resource flows to the poorest countries must be increased by an enlarged replenishment of IDA. The Committee calls for a modest expansion of \$2 billion beyond the resources currently available to IDA and the Special Facility for sub-Saharan Africa. If Africa's special needs are to be met, new mechanisms must be established for co-ordinating and supporting the transfer of substantial additional resources and to facilitate the associated policy dialogue. An underlying consensus on policy for development now exists between African and donor countries. With adequate financial resources and with the political will on both sides, Africa can look forward to a steady recovery and rehabilitation.

14. In addition to the quantity of lending, the multilateral institutions must also improve its quality. They must increase and sustain their commitment to macro-economic programme lending, even at the expense of project loans.

15. On top of their requirements for long-term capital, developing countries will have a separate need for foreign exchange reserves to support expanded trade. An additional \$15 billion of trade-related finance will be needed to support reserve requirements by 1990. The Committee proposes that \$5 billion of this annually should come from a new selective allocation of Special Drawing Rights (SDRs) by the Fund. These SDRs, however, should be viewed only as a source of liquidity. They would not be a substitute for the long-term capital required for development purposes, although they would obviate the unproductive diversion of development finance into foreign exchange reserves.

16. Commercial banks must provide annually about \$13 billion, or about half of the additional resources required by 1990. A return of large-scale voluntary lending is not on the horizon for many developing countries and the sort of large-scale flows seen in the 1970s should not be viewed as the norm to which all policies now must be directed. The aim must be to keep the banks engaged even as they mitigate their over-exposure over time. Nevertheless, additional voluntary commercial lending of \$3 billion annually should be feasible, largely through co-financing with the World Bank.

17. For countries which are unlikely to attract voluntary bank finance, new arrangements to institutionalize "involuntary" lending will be required. In effect, the banks must be induced to plough back into new lending a portion of the interest payments which they are now receiving from the developing countries - the Committee recommends that the sum of \$10 billion annually should be committed to such involuntary lending. This can be done either through partial capitalization of interest or through multi-year new money facilities, which would guarantee countries specified sums of new lending for several years in advance. Capitalization would have the advantage of directing resources to indebted countries in proportion to their debt burdens and of involving banks in proportion to their past commitments. The largest countries are ultimately determined to meet their obligations and will be able to do so within the kind of long-term co-operative framework the Committee recommends.

18. In addition to voluntary and involuntary medium-term lending, banks can be expected to provide, through their ordinary commercial operations, the largest part of the developing countries' trade-related reserve needs. The Committee suggests

that normal short-term trade financing should increase by about \$10 billion a year in line with the expansion of developing countries' imports and exports, which would be part of a growth-oriented global development strategy. Together with the SDR allocations suggested, this trade financing would assure developing countries of the liquidity they need to participate fully in the international trading system.

19. Developing countries will have to formulate economic policies and budgetary plans aimed at promoting growth-oriented economic management, as well as financial prudence. Conditionality is a sensitive subject because it impinges on national policy, but Governments must accept the fact that no nation enjoys full sway over its economic circumstances in an interdependent world economy.

20. IMF conditionality has evoked negative responses, because it has been so strongly weighted to immediate stabilization objectives. What is needed now is a new form of "growth conditionality", with an emphasis on longer-time horizons, expansion of the supply of finance and greater participation of the debtor countries in specifying strategies tailored to their own particular cases. This was a central feature of the European recovery plan in the immediate post-war period and one that was later incorporated in the Alliance for Progress. The expanded role for the World Bank envisaged by the Committee would give this institution a more important say in working out acceptable and implementable agreements.

* * *

21. Development finance must be seen as one of the elements in a global economic challenge. In the absence of expanding export markets, finance will not be a satisfactory solution for the developing countries' problems, even if it becomes available. On the other hand, improvements in capital supply would provide positive feedback on OECD economic expansion. Expansion of development finance would relieve the pressure on the international trading system which emanates from unnaturally large export surpluses run up by the developing countries. Accelerated growth in the developing countries would attract a larger share of the surplus savings of Japan. Larger developing-country markets would help to stimulate recovery of industrial sectors and employment in the United States and Europe.

22. What is at stake is the liberal system of economic interdependence that has underwritten unprecedented rates of economic growth in the post-war period. Secretary Baker's initial instincts in addressing the debt problem were the right ones. Now is the time to go one step further and take on the development challenge.

II. DOUBLING DEVELOPMENT FINANCE: MEETING A GLOBAL CHALLENGE

A. Clearing away the debris of the past

23. Superficially the world economy appears to have weathered the recent debt crisis surprisingly well. There have been no major defaults. Inflation is continuing to fall, as are interest rates and oil prices. Financial expectations are improving as misaligned exchange rates move back towards equilibrium, while the major banks appear more confident of withstanding the strains of their international loans. But this is the world as seen from the developed countries. From the point of view of the developing world, nothing could be further from the truth. The short-term costs of adjustment were large, they are still being felt and no signs of amelioration are in sight. The fall in the oil price has benefited many, but is having a devastating effect on a few major developing countries, notably Nigeria and Mexico. Indeed, on balance, capital importing developing countries are net oil exporters.

24. In particular, for most developing countries, the improvement in international economic conditions, even if sustained, will not resolve a critical and urgent problem - how to clear up the debris left over from a period of international financial crisis which may now be receding, but which continues to dominate every aspect of political and economic life in much of the third world.

25. The contrast between the prospects of developing and industrialized countries emerges starkly in any analysis of international economic conditions. The industrialized nations can probably expect continued growth in the 3 to 3.5 per cent range. This performance would compare well with the long-term trends established by industrialized countries since the early 1970s (see table 1), although it would do little or nothing to resolve the unemployment problem.

26. Most developing countries face a much bleaker outlook for the years ahead. For the developing world as a whole, a 3 per cent growth rate also seems in prospect this year, even after the oil price and interest rate declines of the last few months. In contrast to the industrialized countries, such a growth rate would represent less than half the average performance of the early 1970s. More importantly, when viewed against the rising populations of the third world countries, this forecast provides for little or no improvement in living standards or employment opportunities in most developing countries for the fifth successive year. The prospects to the end of the decade are not much better. The IMF projects a growth rate of 4.7 per cent per year for the period 1988 to 1991, implying a per capita income growth of 2.7 per cent, well below the 3.4 per cent of the 1970s.

27. The gloom, of course, is not universal. China and India, which account for one third of the world's population, have been doing much better in the 1980s than they did in the previous decade and they should continue to enjoy adequate growth.

28. In most of the countries of Africa, Western Asia and Latin America, however, the latest forecasts suggest that per capita incomes will continue to decline, or at best stagnate. In fact, in Latin America, except in Brazil, a significant economic deceleration appears to be under way already, only two years after the start of a recovery from the Continent's deepest depression this century. Looking further ahead, there seems, on present trends, to be little reason to hope for major improvements in any of these regions, even if the industrialized world sustains its present moderate growth.

Table 1. Growth of world output and world trade, 1971-1987

(Average annual change, in percentage)

	1971- 1975	1976- 1980	1981- 1985	1984	1985 <u>a/</u>	1986 <u>b/</u>	1987 <u>b/</u>
<u>World c/</u>	4.2	3.9	2.7	4.7	3.3	3.5	3.7
<u>Developed market economies</u>	3.1	3.5	2.3	4.8	2.7	3.1	3.3
North America	2.8	3.6	2.6	6.6	2.4	3.3	3.6
Western Europe	2.9	3.9	1.3	2.2	2.4	2.7	2.8
Japan	4.6	5.1	4.0	5.1	4.2	3.0	3.7
<u>Developing economies</u>	6.2	4.9	1.4	2.0	2.4	3.0	3.5
Africa	5.1	4.6	-0.6	-0.7	1.4	2.5	
Western Hemisphere	5.9	5.1	0.5	3.1	2.8	2.0	
West Asia	9.4	3.6	-1.1	-3.5	-0.3	2.0	
Mediterranean	6.2	4.3	2.7	3.9	3.3	2.5	
South and East Asia (India)	5.2 (3.0)	6.1 (3.4)	4.9 (4.7)	5.1 (4.9)	3.8 (4.5)	4.2 (4.5)	
<u>Centrally planned economies d/</u>	6.2	4.5	4.5	6.2	5.3	4.9	4.8
USSR and Eastern Europe	6.3	4.1	3.0	3.8	3.1	4.0	4.0
China	5.5	6.0	9.8	14.6	12.3	7.5	7.0
<u>International trade e/</u>	5.0	5.1	2.8	9.0	3.2	4.0	4.5

Source: United Nations, World Economic Survey, 1986 (forthcoming).a/ Preliminary estimates.b/ Forecasts (based on Project LINK and other institutional forecasts).
Figures for centrally planned economies for 1986 and 1987 are plan estimates.c/ Output data for these country groups and for each Member State are aggregated with weights estimated on the basis of 1980 prices and dollar exchange rates. For some countries, fiscal year figures have been adjusted to conform to the calendar year.d/ Net material product.e/ Arithmetic average of export and import volume growth rates.

29. There are, of course, a multitude of country-specific reasons why certain developing nations are failing to share fully in the economic recovery, which is now in its fourth year in the industrialized world, but there is one common factor which accounts for many of the economic disappointments throughout the developing world.

30. Almost all developing countries, whether low- or middle-income, indebted or still relatively unencumbered, face a large and growing financing gap over the next decade. Closing this gap, the Committee believes, is a global challenge which will require policy responses on a global scale. The cost of inaction will be intolerably low growth rates for many more years to come in much of the developing world and a slowdown of growth in the industrial countries.

31. Sub-Saharan Africa is caught in a pincer movement between domestic economic disruption and growing financial demands from abroad. Even with the policy improvements which their Governments are now attempting, many African countries will have little hope of economic rehabilitation until there is relief from their present financial burdens and injection of new external funds.

32. In Latin America, Governments have made great efforts to improve domestic economic management. Yet some of these countries are finding the burden of debt service so oppressive that, in the absence of bold initiatives from the industrialized world, they may be pushed towards protectionism, autarky and default - to everyone's disadvantage.

33. The shadow of the financial crisis extends to the less-indebted developing countries. Even in China and India, which have followed a more self-reliant strategy, additional external capital would greatly assist further economic liberalization and higher growth.

34. The consequences of the developing countries' hardship also affect the industrialized countries. Even ignoring the possibility of default, which would threaten every economy, every capital market and every major trading company in the world, unprecedented financial strains in the developing countries have damaged industrialized countries' third world export markets. The recent global dislocations from which these difficulties derive are fresh in living memory and need not be recounted here. Yet the world is not sufficiently aware of their long-term development implications.

35. For the first time in post-war economic history, the international flow of financial resources has turned in a perverse direction on a large scale. Since 1982, real resources have moved from some of the poorest countries in the world to the richest - from economies where labour is cheap and capital deficient to those where labour is costly and capital relatively abundant (see box 1). And, although the industrialized economies have recovered and domestic policies in many developing countries have improved, these reverse cash flows continue and, if current policies prevail, will do so for at least another decade.

Box 1: Net resource transfers

This concept has come into popular use in recent years as increased interest payments on the external debt of developing countries have exceeded net capital inflow. It is computed by subtracting return factor payments (net investment income) from the net flow of capital.

Countries may still be importers of capital, as virtually all developing countries are, because they have current account deficits, although their net resource flows are negative.

Net resource flows focus upon the trade balance and hence the increment to the domestic supply of resources. A trade surplus is needed if interest and other factor income payments exceed capital inflows (excluding changes in reserves). Indebted developing countries and developing countries in general are now in this situation. But trade surpluses imply that domestic expenditure must be less than output; part of production is not available for domestic use. This situation is not sustainable. In the longer run, debt can be serviced only from growing income, which is incompatible with premature import compression.

Capital importing countries must naturally expect that, as their production levels increase, at some point they will be in a position of reducing expenditures to meet their external obligations. But the recent trade surpluses have not emerged as a consequence of gradually increasing export capability and higher domestic savings, but rather have resulted from drastic reductions in imports and investment.

Because these capital-poor developing countries can expect at their present level of development to see their savings supplemented by inflows from abroad, the reverse resource transfer of recent years must be regarded as an aberration. That is why capital inflows should again rise, even while countries continue to give emphasis to export growth. Sufficiently increased capital should allow developing countries to implement projects which yield a rate of return higher than the rate of interest on borrowed capital and to augment export capability.

The following table both illustrates the concepts and the reversal that has occurred. For Latin America in particular, the magnitudes involved are very high. According to calculations made by the Economic Commission for Latin America and the Caribbean (ECLAC), the net outflow of real resources from the countries of this region towards the rest of the world has approached 4 per cent of its GDP per year since 1983, as compared with an inflow of more than 1 per cent, on the average, in the decade of the 1970s. 2/

Capital-importing developing countries: a/
net resource transfers

(Billions of dollars)

	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u> b/
1. Trade balance (goods and non-capital services) (Latin America) c/	-24 (-10)	-45 (-13)	-34 (1)	3 (27)	30 (35)	32 (30)
2. Current account balance	-61	-93	-97	-57	-36	-35
3. Net capital flows d/	77	90	74	60	53	36
3.1 Net borrowing	(54)	(62)	(51)	(40)	(32)	(13)
4. Net investment income	-37	-48	-63	-60	-65	-67
4.1 Interest payments	(-24)	(-35)	(-50)	(-48)	(-54)	(-54)
5. Net resource transfer	39	41	10	-0	-12	-31
(Latin America) c/	(11)	(9)	(-18)	(-30)	(-25)	(-30)
6. Net transfer on debt account	31	28	1	-9	-22	-41

Source: United Nations, World Economic Survey 1986 (forthcoming), based on data from IMF, Balance of Payments Statistics, national data and estimates of the World Bank, United Nations regional commissions and other sources.

a/ Sample of 93 developing countries.

b/ Preliminary estimates.

c/ See footnote 1.

d/ Includes all official bilateral and multilateral credits, all private credits, short-term as well as long-term, direct investment flows and official grants.

36. Without a restoration of development finance, the prospect for adequate growth and social progress in many of the world's poorest countries will remain negligible, whatever efforts their Governments make to put their own house in order. Certainly, 4 per cent growth in the developing world is unlikely to satisfy even the minimal aspirations for the creation of employment and higher living standards.

37. The last few months have seen signs of a new more positive approach to international development policy. The initiative taken by United States Treasury Secretary James Baker at the IMF-World Bank Annual Meetings in Seoul last October signalled leadership with new ideas. But, six months later the political momentum appears already to be flagging. And we are concerned that current forecasts of benefits from falling oil prices will once again distract international economic leadership into a dangerous complacency.

38. Without decisive international action, the debris of the past will continue to impede economic progress in many developing countries. Clearing these obstacles away will require a complex and challenging partnership between the four groups of participants in the present crisis of development finance: the developing countries, the Governments of industrialized nations, the commercial banks and the multilateral financial institutions. All four groups will need to contribute to the effort, to accept some constraints on their actions and to bear some of the costs. However, an integrated approach to capital flows and development will ultimately be beneficial to all of them. Short-term losses can be minimized and limited to tolerable levels through a genuinely co-operative approach. The costs of finding a fundamental solution to the chronic financial crises in the developing countries will certainly be smaller than the costs of degeneration into economic anarchy or a decade of stagnating living standards in much of the developing world.

39. The present report proposes a plan for such a co-operative effort to clear away the debris of the past and rebuild the foundations for sustainable growth. We appeal not to the altruism, but to the self-interest of the protagonists in the nexus of development and debt. The developing countries, the Governments of industrialized countries and the shareholders of major banks all need a programme built on realism, not just on lofty ideals or wishful thinking. It must be a programme that will work within the institutional and political constraints which exist in the world as it is today. Our proposals, accordingly, are only a minimum agenda for action. They are not more than the necessary steps for preventing further economic depression and restoring conditions for moderate but sustainable growth. At a time when the legacy of the past constrains the ability of many Governments to deal effectively with pressing problems, even this is an ambitious goal.

40. The next section outlines the general analysis behind the Committee's recommendations. In section C, the quantitative estimates of the developing countries' long-term capital requirements, which form the nub of the present problem, are discussed. Section D deals with the special needs of sub-Saharan Africa. Specific policy recommendations of the Committee are presented in section E below.

B. A crisis of development finance

41. The adjustment policies prescribed for the developing countries have focused primarily on meeting short-term balance-of-payments requirements. In this respect the emergency responses of the past four years have proved remarkably successful. Unprecedented collaboration between commercial banks, multilateral institutions, Western monetary authorities and the Governments of heavily indebted developing countries succeeded in marshalling just enough resources to meet the developing countries' immediate obligations to the international banks and, consequently, in preserving the solvency of the international financial system. The debtor countries, in exchange, submitted their economies to severe deflationary adjustments.

42. By 1985, however, it was becoming apparent to all that the framework for adjustment put together in 1982 imposed heavy costs not only on the developing countries, but also on the industrialized world. Because of its very success in reversing the cash flows between developing and industrialized countries, the initial response to the debt crisis gave rise to profound development problems, embracing not only the heavily indebted countries of Latin America, but extending also to sub-Saharan Africa and even to some of the industrializing countries in Asia.

43. Improved external performance did not restore creditworthiness. Meanwhile the apparent financial successes of this approach to adjustment merely relieved the panic among bankers during the early phase of the debt crisis. The "debt bomb" of the newspaper headlines had turned out to be more like a debt cancer - less dramatic, but just as destructive.

44. By 1985, commercial banks had almost ceased net lending to developing countries, the disbursements of official agencies had stagnated and the third world was in the position of supplying more funds to the financial markets than it was borrowing for the third successive year. The stream of the negative cash flows on debt account, comparing net borrowing and return interest payments, was swelling - \$9 billion in 1983, \$22 billion in 1984 and an estimated \$41 billion last year (see box 1). The squeeze on the trade balance of the capital-importing developing countries since 1981 has exceeded \$75 billion. Since imports have declined by \$60 billion, while exports have increased by \$15 billion, the adjustment has been primarily at the expense of domestic absorption and growth. Growth rates have averaged less than 2 per cent during the period from 1982 to 1985, compared with over 5 per cent during the period from 1973 to 1980, and living standards have declined in the majority of developing countries. In most indebted countries, progressively larger proportions of savings have been diverted from investment to the service of external debts. While stabilization programmes have been successful in making possible the trade surpluses necessary to effect this transfer, very often they have done so at the expense of increasing internal disequilibrium and deterioration of the income distribution.

45. These results have contradicted the fundamental assumption on which the adjustment programmes had been based. This was the belief that a small group of countries were confronting a liquidity crisis of brief duration when, in fact, there had been a fundamental disruption in the whole system of financing development for much of the world.

46. Even as recently as a year ago, the view that the debt crisis was now definitively behind us had wide currency. Such optimism took heart from the developing-country export surge of 1984 and falling interest rates. It was argued that a combination of adjustment in developing countries and growth in the industrialized countries would restore the creditworthiness of the third world. A return to the status quo ante in the financial markets would gradually restore the flows of private capital, providing developing countries with the resources required for growth, but this time without the excesses of borrowing and lending of the 1970s.

47. There were three fundamental deficiencies in this view. One was an exaggeration of the reliability of the OECD-developing country trade linkage. The second was an unrealistic view of adjustment possibilities. The third was a neglect of the dramatic change in the structure and psychology of the international capital markets.

48. Developing countries cannot simply export their way out of their difficulties if OECD growth is maintained at a threshold average rate of, say, 3 per cent; the statistical evidence suggests smaller effects on least-developing-country trade than are assumed in the most optimistic forecasts. ^{3/} There are uncertainties about increasing protectionism and commodity prices, as well as inevitable cyclical fluctuations in which relapses will occur.

49. The second objection to the emphasis upon least-developing-country adjustment is its excessive preoccupation with the balance of payments. The need to generate a trade surplus sufficient to finance the servicing of foreign debt cannot remain indefinitely as the central objective of developing country economic policy. Ruthless import compression is restricting the growth of production and consumption in developing countries. It is also pushing them further in a protectionist direction, diametrically opposed to both the perceived interests and the announced policies of the major creditor countries. More importantly, it is undermining domestic capital formation, which will determine future creditworthiness, as well as the living standards, of the developing countries. When domestic consumption can be compressed no further, excessive export surpluses can only be generated at the expense of domestic capital formation. Even successful export drives, especially when these have to rely on large volume increases to offset declining terms of trade, can prejudice domestic investment, rather than stimulate it. Thus, the success of developing-country adjustment cannot be gauged simply by the balance of payments. It must also reflect the magnitude and efficiency of investment.

50. The third and decisive weakness of the liquidity-crisis diagnosis is its assumption that private financial flows will be spontaneously restored. This view is ahistorical and ignores the far-reaching changes in international capital markets of even the last few years. It would take much more than a return to former debt-export and bank-capital ratios to stimulate a new and steady flow of private-bank lending to the third world. Past experience with international financial cycles makes clear that, once exaggerated enthusiasm for sovereign lending has been deflated, capital markets overshoot in the other direction, denying even seemingly creditworthy borrowers. A return to large-scale voluntary lending is therefore not on the horizon for many developing countries. Moreover, even if such lending were to become available, it is important to ask whether reverting to the recent reliance of development on private short-term finance would be desirable. The 1970s are better viewed as an aberration in the pattern of capital supply to developing countries, a temporary response to the special circumstances of the petro-dollar surplus, rather than the norm which all policies must now aim to recreate.

51. There are good grounds, therefore, for disaffection with the present approach to development finance. Not only is it becoming politically unacceptable in many developing countries but, far from moving the world economy towards greater financial stability, freer trade and faster growth, present policies are generating powerful pressures in the opposite direction. There is nothing surprising about this. The ad hoc policies put together in 1982 were an emergency response to an unexpected crisis. They were never thought out from a longer-term perspective and it was never plausible, even perhaps to their original proponents, that the kind of contractionary adjustment through demand deflation traditionally prescribed by the International Monetary Fund (IMF) for short-term liquidity crises could form the basis of a positive new approach to development and international capital flows.

52. Today, it is not in anybody's interest to preserve a rigid and frozen status quo. An opportunity exists, therefore, to move international development, adjustment and financial policies, by consent, in a new and more productive direction. No single - or simple - set of policies will suffice. Proposals which rely on the automatic benefits of OECD growth and debtor-country "adjustment" are no more realistic than those which advocate default and autarkic self-reliance.

53. Instead, four interdependent components will be necessary in order to restore international financial stability and adequate developing-country growth. These are:

(a) Industrialized-country Governments will promote an international economic environment with lower interest rates and a dynamic receptiveness to developing-country imports; they will also have to provide larger resources or the official and multilateral financial institutions;

(b) The multilateral development institutions, particularly the World Bank, will need to rise far more vigorously to the challenge. A doubling of the World Bank's net annual disbursements by the end of the decade, accompanied by a further reorientation from project-lending to programme-lending, will be needed to restore the Bank to its traditional position as the primary source of international development finance;

(c) Commercial banks will have to enter new types of agreements with heavily indebted developing countries, which will institutionalize some form of multi-year "involuntary" lending as a reward for effective development strategies. Major debtors will need to obtain reliable long-term commitments to smaller net outflows to assist them in financing their development programmes. Certain debtors might also require limited reductions in past obligations, to be agreed on a strictly case-by-case basis. However, the majority - and the largest borrowers - could support the gradual and controlled growth of debt burdens which would result from capitalization or new money commitments, once they were provided with the stable sources of finance they need to regain adequate rates of economic growth;

(d) Developing countries will have to formulate economic policies and budgetary plans aimed at promoting growth-oriented economic management, as well as financial prudence. Policy reforms will have to be designed in accordance with their own priorities and implemented in co-operative agreement with financial institutions within the framework of a new "conditionality for development". Unforeseen events will make adjustment of programme targets inevitable, and mechanisms should be agreed in advance for avoiding time-consuming and disruptive renegotiations.

54. All these measures presuppose the acceptance of a larger role by the Governments of the industrialized countries and particularly by the World Bank. Until now, Governments have responded to the immediate crises by expressing support for the International Monetary Fund and cajoling commercial bankers. Much more than this is needed, however. The Baker initiative is a first and welcome step in this direction. However, this initiative encompasses only the largest "problem debtors". Even more important, it appears to underestimate significantly the financial requirements of the developing countries and the reallocation of flows that will be necessitated if oil prices remain low.

55. It is hard to reconcile the Baker initiative's objective of accelerated growth in developing countries with its very modest financial demands on banks and multilateral institutions. The starting point of any realistic policy to promote growth in the third world must be a recognition that developing countries will require far greater foreign financing than now appears to be in prospect. This is the theme of the next section.

C. Capital requirements for development and growth

1. Overall requirements

56. The capital flows required to finance current-account deficits in the coming years are now the critical constraint on growth in most developing countries. These current-account deficits may be the consequence of interest payments on massive debt burdens, as in most of the Latin American countries and large debtors in general. Alternatively, the deficits, and their concomitant capital requirements, may arise mainly from accelerating growth along with import liberalization, as in several Asian countries. In much of low-income sub-Saharan Africa, foreign capital inflows will be needed, even on the most favourable assumptions about domestic policy reform, simply to bridge the gap between these countries' minimum import requirements and their dwindling earnings from exports of commodities, including oil. In all these cases, the current-account deficits required for adequate growth and adjustment exceed the sums now likely to be available from official sources and private markets.

57. Table 2 sets out projections of developing-country current-account deficits to 1990 and 1995 under present conditions of capital supply. These projections, which reflect current official views, imply that developing countries will have to delay their recovery still longer than was expected a year ago. ^{4/} This is not an acceptable option - developing-country growth should be the determining objective, not the residual emerging from inadequate supply of finance for the developing world.

58. The stringency of finance, which is now incorporated in official projections, takes its toll despite the relatively favourable trade performance of indebted developing countries in recent years. Overall, there is now a trade surplus, hard won through the severe reduction in imports and growth since 1981. Dominating the economic strategy of debtor developing countries has been an imposed austerity to attain creditworthiness. But postponement of growth has not resolved the problem. Even as these countries have improved their external accounts, available finance has shrunk. They are now, in effect, being counselled to await a massive increase in private capital flows in the 1990s, which is implicit in table 2, for the necessary finance to appear. Indeed, the limited 1990 current-account deficit, despite a reversal of the trade surplus, occurs only because of assumed increases in private transfers. In their absence, import growth could not be financed.

59. As was noted in the previous chapter, such a return to earlier conditions of capital supply can hardly be taken for granted, even under assumptions of stronger industrialized-country growth. Financial markets have definitively changed. It may take many years, as has typically happened with international lending before, for voluntary credit spontaneously to resume.

60. The debtor countries' realism about financial constraints must now go hand-in-hand with political realism from the industrial countries and the banks. Debtor countries have to make a transition from austerity to satisfactory rates of growth. Debtors increasingly threaten to take matters into their own hands by reducing interest payments to provide the needed resources. Some have already done so. It will not take much, even a partial inability to service debt by a major borrower, to undermine many of the assumptions on which the present complacency is based, not least the hopes for a return of confidence among commercial lenders.

Table 2A

Capital-importing developing countries: a/ Finance-constrained
projections of current-account deficits, 1990 and 1995

(Billions of 1985 dollars) b/

	1980	1985	1990	1995
Current account deficit	<u>88</u>	<u>38</u>	<u>46</u>	<u>75</u>
% GNP	3.3	1.6	1.3	1.6
Current account deficit plus increase in reserves <u>c/</u>	<u>105</u>	<u>43</u>	<u>70</u>	<u>106</u>
Trade deficits <u>d/</u>	<u>54</u>	<u>-7</u>	<u>16</u>	<u>49</u>
% Current account	79.0	-18.5	33.6	65.8
Interest payments	<u>43</u>	<u>58</u>	<u>55</u>	<u>52</u>
% Current account	48.4	150.5	119.3	69.3
% Exports <u>e/</u>	9.0	11.1	8.1	5.7
% GNP	1.6	2.4	1.6	1.2
Debt	<u>560</u>	<u>720</u>	<u>704</u>	<u>757</u>
% Exports <u>e/</u>	89.8	139.2	102.9	83.0
% GNP	20.9	30.5	20.1	16.6

Source: A. Fishlow, "Capital requirements for developing countries in the next decade", Technical Study prepared for the Committee for Development Planning. Ratios and constant dollar levels calculated by the author are based on current dollar projections provided by the Economic Analysis and Projections Department of the World Bank.

a/ World Bank Country Panel; includes China, Greece, Portugal, Turkey and a sample of 86 developing countries.

b/ Deflated by United States GDP Price Index.

c/ Change in reserves for 1995 was recalculated from original data to reflect a constant 3.5-month reserve level.

d/ Goods and non-factor services.

e/ Goods and services.

Table 2B

Key assumptions

(Annual growth rates) a/

	1985-1990	1990-1995
OECD growth	3.1	3.4
Nominal interest rate (average level)	8.7	7.5
United States GDP deflator	4.8	4.5
Real price of oil	-8.5	6.6
Export-merchandise volume	5.0	5.0
Export prices	5.8	5.3
Import-merchandise volume	5.9	6.1
Terms of trade	0.4	0.7
Real private credit growth		
Long-term	-10.4	16.4
Total (including short-term)	3.7	19.0
Real official-credit growth	-1.2	3.9
Developing-country growth	4.7	5.3

a/ Unless otherwise stated.

61. But, even if a relatively favourable 5 per cent annual average growth rate - well above recent experience but below trend growth - could be achieved on present policies, it would be unlikely to prove sufficient. Population is growing by 2 per cent a year on average in the developing countries and labour-force expansion is even more rapid. Assuming a 2.5 per cent improvement in productivity each year, it requires 5 per cent growth in developing countries as a whole just to prevent unemployment from rising. And in Latin America where the labour force is growing faster, a minimum GDP growth of 6 per cent per year is required just to check the rise of unemployment in the major urban centres (see box 2). But in reality the challenge is far greater.

62. Much of the developing world, the large Asian countries prominently excepted, has just lived through its worst recession since the 1930s. During a recovery period, Governments and nations quite justifiably expect their economies to grow more rapidly than their long-term trend growth rates, so as to absorb unemployed workers and other idle resources. Thus, the kind of growth assumptions built into even the more optimistic official projections are in effect condemning many developing countries to massive endemic unemployment.

63. To make matters worse, the commonly-quoted projections of the type given in table 2, which necessarily aggregate results for groups of developing countries, disguise major disparities in national performance. It is at the national level that the success and sustainability of economic policies must be judged, and the poor performance of individual countries or regions is all too likely to have an impact on the private financial markets' assessment of other countries. Under present institutional arrangements, this kind of financial contagion could be expected to spread the problems of one developing country or group to many of the others, just as it did after the Mexican crisis of 1982. This, for example, is one of the dangers of the present price shock to oil exporters, which has cast new doubt on the financial stability of several debtor countries.

64. What, then, would be required to offer developing countries sufficient prospects of a return to financial stability and adequate levels of economic growth? Today, there are two standard answers: improved policies in the developing countries themselves and better OECD economic performance. Domestic policy reform is obviously critical - and will be reflected in the recommendations of the Committee. But it is a cruel deception to suggest that adjustment alone can lift the constraints imposed by foreign finance. Quite the contrary. Finance is now necessary to sustain and reinforce reforms. Restoration of investment and growth will make the accumulation of savings and increase of export-capacity much easier.

65. Developing-country measures to liberalize imports can only go hand-in-hand with adequate finance. This is precisely what has been happening during the past few years in some countries of Asia and it has contributed to faster economic growth. Other developing countries have been less fortunate; they have had to contract their imports to defend their precarious payments balances.

Box 2. Growth and employment in developing countries

One of the major problems facing the developing countries is the existence of high unemployment and a rapidly growing labour force. The ILO projects labour-force growth at over 2 per cent per annum during the period 1980 to 2000, but this average figure alone does not portray the gravity of the problem. For instance, urban open unemployment in Chile for 1984 was estimated at 18.5 per cent and in Venezuela at 13.9. ^{5/} Such a large, idle labour force, which does not include underemployment, poses serious threats to political stability, on which sustained economic growth depends.

The Economic Commission for Latin America and the Caribbean points out in a recent document that, even in the case of the most optimistic growth scenarios for the region, "... employment would not be sufficiently dynamic to cause the employment problem to resolve itself in a reasonable length of time." ^{6/}

This conclusion was reached under the assumption that GDP would grow at an annual rate of 5.3 per cent between 1985 and 1990, 6.4 per cent thereafter until 1995, and that productivity would grow at an annual average rate of 2.3 per cent. Under those assumptions and given that the work force is projected to expand at around 2.7 per cent per year, unemployment and underemployment would actually increase between 1985 and 1990 from 23.5 per cent of the work force to 24.1 per cent and would only slightly decrease by 1995 (to 20.0 per cent).

It was estimated that for unemployment and underemployment levels to remain at the same levels of 1985 by 1995, the region would have to grow at a cumulative annual rate of over 6 per cent; while, if a more ambitious goal of absorbing all of the work force by 1995 were established, the region's economy would have to grow at the clearly unattainable rate of 8.2 per cent.

The conceptual and statistical difficulties associated with the measurement of the partly employed (not to mention the pools of disguised unemployed), makes an assessment of the extent of unemployment in developing countries difficult. However, it appears that it is of a much greater magnitude than the statistics indicate. This emphasizes the need for not only a higher rate of growth of domestic product, but the kind of growth which will ensure greater employment opportunities.

66. Adequate performance of OECD countries is a further necessary condition. A combination of much more rapid OECD growth, substantially lower interest rates and fewer protectionist barriers could conceivably allow many developing countries to accelerate economic growth and support their present financial burdens unaided, provided they followed appropriate policies (box 3). In reality, however, it is over-optimistic to assume in the OECD economies the kind of rapid and continuous growth, with low interest rates which could, on its own, resolve the developing countries' financial needs for adequate growth. The present optimism in some quarters, engendered by the oil price decline, must be tempered by the realization that shocks - even positive ones - create important adjustment problems. The collapse in the oil price, if it is sustained, will accomplish a major redistribution of income around the world, but it is by no means clear whether it will lead to a permanent acceleration of OECD growth and developing-country trade. Moreover, a shift in favour of Japan and the Federal Republic of Germany may not lead to the same receptivity to imports inherent in the large United States trade deficits in recent years. Indeed, the latest International Monetary Fund projections suggest that, on balance, the effect of lower oil prices on the growth of indebted developing countries in the aggregate will be marginally unfavourable.

67. For different external environments, table 3 provides more specific indications of the capital flows which will be required if the developing countries are to return to reasonable rates of growth and development. Our figures make bare-minimum assumptions about the growth necessary in the developing world. We assume growth of 5.3 per cent a year between 1985 and 1990 for Latin America, compared with the wholly inadequate 4.4 per cent rate which appears feasible under the present financial constraints. For other developing countries we stipulate 5.1 per cent instead of the 4.7 per cent finance constrained rate assumed feasible. During the period 1990-1995, the development determined rates are 5.5 per cent for both groups. These may seem very modest improvements, but, over a period of years, they cumulate to substantial differences in living standards, development prospects and jobs.

68. The calculations show that developing countries require substantial new resources to attain such rates, even on the assumption of low oil prices, faster OECD growth and relatively low interest rates (see table 3 "Favourable scenario"). In a "Central scenario", which assumes a slightly less buoyant external environment with OECD growth of 3.1 per cent and interest rates under 9 per cent from 1985 to 1990, the financial and policy challenge is truly formidable.

69. Three major conclusions follow from the totals for all developing countries in table 3. First, even in the most favourable external environment, the residual financial needs, after taking into account current projections of official transfers and lending, as well as private investment, are substantial. An order of \$25 billion (in 1985 dollars) in private finance would be needed in 1990 and a larger \$60 billion (in 1985 dollars) in 1995. Those amounts imply a significant growth in private lending from the \$10 to \$15 billion level that seems to have prevailed in 1985. Such sums may be feasible, especially in the much more buoyant and favourable external environment assumed. But they cannot be taken for granted.

Box 3

OECD growth rates, interest rates and financing requirements
of developing countries in 1990

OECD growth rates influence export growth rates of developing countries through both volume and price effects. The strength of those effects is subject to some uncertainty. Different country groupings, years of analysis and statistical specifications lead to different results. Moreover, the range around predicted results is considerable. The tabulation below is on the optimistic side, assuming a marginal elasticity of 1.6 for export volume and .5 for terms of trade effects. With increased protectionism, shifts in the pattern of global growth and continuing sluggish commodity prices, the effects may be smaller.

Changes in interest rates directly affect payments of debtor countries. But their effect is limited for three reasons. First, for the group of all borrowing developing countries taken together, fixed-interest-rate debt amounts to about half of all obligations. Second, declines in interest rates also reduce earnings on reserves. Third, the export effects compound over time so that, even over a five-year span, they become progressively larger. For large debtors, the immediate import effect of interest rates is much greater. Note, moreover, that lower interest rates exert a positive influence by increasing the creditworthiness of borrowers. Because of smaller payments, they can support higher debt levels.

For different assumed OECD growth rates and interest rates for 1987-1990, and developing-country growth rates of table 2, financial requirements of developing countries in 1990 are estimated as follows:

LIBOR <u>a/</u> interest rates	<u>6.5</u>	<u>8</u>	<u>9.5</u>
OECD growth rates (Percentage)	Financial requirements, 1990 (Billions of 1985 dollars)		
2.7	87	92	96
2.9	76	80	85
3.1	65	69	73
3.3	53	57	61
3.5	42	45	49

Source: A. Fishlow, "Capital requirements for developing countries in the next decade", Technical study prepared for the Committee for Development Planning.

a/ London interbank offered rate.

The value of \$69 billion for 3.1 per cent OECD growth and LIBOR of 8 per cent corresponds to the \$70 current-account deficit plus reserve acquisition for 1990 shown in table 2. A more favourable external environment reduces financing needs in the indicated fashion.

On the other hand, higher developing-country growth requires greater financial flows whose size depends upon the marginal import elasticity and need for added reserves. Each additional percentage point of import growth implies about \$35 billion (1985 dollars) more financing in 1990. With an import elasticity in the range of 1.3 to 1.5., that means each additional point of developing-country growth costs about \$50 billion (1985 dollars).

Accelerating developing-country growth from its projected 4.7 per cent annually in the period 1985-1990 to 5.2 per cent would imply an additional \$25 billion (1985 dollars) in finance in 1990, over and above the \$70 billion (including reserve acquisition) embedded in the estimates of table 2.

This higher developing-country growth could be alternatively achieved through improved balance-of-payments deriving from higher OECD growth and lower interest rates and applying the gain to larger imports. But it would not be easy; it would take sustained OECD growth of 3.5 per cent per year and 6.5 per cent LIBOR during 1987-1990 to achieve the higher growth.

Table 3

Capital-importing developing countries: a/ Projection of financial requirements for 1990 and 1995

(Billions of 1985 dollars)

	Finance constrained b/				Development determined c/								
	1990		1995		Central scenario d/				Favourable scenario e/				
	Current		Current		1990		1995		1990		1995		
	account	Total g/	account	Total g/	account	Total g/	account	Total g/	account	Total g/	account	Total g/	
ALL DEVELOPING COUNTRIES f/	46	70	75	106	69	91	122	148	54	74	97	121	
Non-Latin America	34	52	43	70	42	60	68	88	30	46	45	64	
Large Asian	10	15	15	20	11	13	16	19	9	11	12	15	
					(27	31	54	60	24	28	52	58
					(
Latin America	13	18	32	36	(
					(
					(h/	20	25	45	50	17	21	44	48

Source: A. Fishlow, "Capital requirements for developing countries in the next decade", Technical study prepared for the Committee for Development Planning.

a/ Includes China, Greece, Portugal, Turkey and 86 developing countries.

b/ From table 2.

c/ Based on higher-target developing-country growth rates (and hence import requirements).

d/ Moderate OECD growth and other assumptions for external environment as in the Finance Constrained Scenario (table 2).

e/ Assumes higher OECD growth rate (3.4 per cent per year for the period 1986-1990), lower interest rates (7.7 per cent for 1986-1990 and 7.5 per cent for 1990-1995) and an oil price of \$17 per barrel for 1986-1990).

f/ All developing countries is the sum of Latin America and non-Latin America for development-determined projections. May not add due to rounding.

g/ Including reserve acquisitions. For development-determined scenarios, reserves are assumed to accumulate at a rate equivalent to three months of imports.

h/ Saving-constrained estimates; see paras. 77-79.

70. Second, for purposes of policy planning, it is reckless to rely on the OECD deus ex machina. It is a rationalization of complacent inaction. The larger levels of required finance, amounting to about an additional \$15 billion in 1990 (1985 dollars) in the more probable central scenario, are the relevant targets towards which one should aim. If, by chance, the world turns out so much more favourably, the added finance would certainly be able to be productively employed in even more rapid recovery by developing countries, contributing in turn to global growth.

71. Third, the additional debt burden to 1990 implied by such central scenario financing can be absorbed by developing countries without distorting their future payments capacity. The debt-export ratios of all developing countries would decline from about 1.7 in 1985 to 1.3 in 1990. Current-account deficits would rise, reflecting higher levels of finance, but would remain below 3 per cent of GDP in 1990. Adjustment through growth allows continuing exports; adequate finance provides the wherewithal for continuing imports and debt service as the net resource outflow is reversed.

72. The progressively larger financial requirements for 1995 implicit in the central scenario also underline the need for complementary domestic policies if higher growth rates are to be sustained. Implicit in the projections is a significant reduction in import elasticities. But countries will have to save more, export more and substitute efficiently for present import requirements to make a growth path of around 5.5 per cent feasible. Otherwise, they will become overexposed and vulnerable to excess debt-service charges again. Finance should and can be used in the near term to reinforce investment in order to reduce financial needs in the longer term. It is not a substitute for sound adjustment.

73. Beyond those aggregate conclusions, it is necessary to look at the evolution of individual country groupings. The Latin American countries, and countries indebted to the private sector more generally, are experiencing one type of financial constraint, the sub-Saharan African countries another and the larger Asian countries still another.

2. The major debtor countries

74. The external payments of the heavily indebted market economies, epitomized by Latin America with its close to \$400 billion level of debt, are dominated by the outward flows of interest payments. They have borne the brunt of IMF stabilization programmes directed to the immediate provision of large trade surpluses. Central to this strategy has been the emphasis on increased exports and reduced domestic absorption as a means of providing the foreign exchange for servicing the debt, restoring creditworthiness and initiating renewed growth.

75. Implicitly the programmes have recognized only one debt transfer problem, that is, the external one, which involves the conversion of domestic resources to marketable exports. But there is another internal transfer problem that has caused immense economic disruption. The primary burden of external-debt payments typically falls on the public sector in Latin America. Governments must therefore gain command of the resources required for interest payments from the private sector. It is not easy to do this without adverse productive or distributional effects when interest payments attain, and frequently exceed, 5 per cent of total GDP. Large dislocations have been involved, and the ultimate burden has been a disproportionate decline of domestic investment. High domestic real interest rates

have not induced greater savings, but rather lower levels of capital formation. The public sector increasingly has accumulated an internal debt in order to obtain the resources needed to service its external obligations. Interest payments on this internal debt have introduced new rigidities into fiscal policy and contributed to an alarming acceleration of inflation. Increased taxes have frequently been regressive or have created disincentives to new capital formation. Lower real wages and higher real interest rates have had a counterpart in worsened income distributions. The external-debt burden has thus insinuated itself into every aspect of economic life. Large negative net-resource transfers of an order of \$40 billion in the last two years (see box 1) have become a profound impediment to sound and equitable economic growth. Such an impasse cannot be tolerated forever.

76. Of course the internal transfer problem reflects internal rigidities that are political as well as economic. Those rigidities were among the reasons why Latin American countries opted for debt in response to the oil shocks in the first instance. But past finance did not go exclusively to facilitating adjustment. In many cases there were mistakes and a few countries have suffered from large capital flight. On balance, however, substantial resources were directed to productive investment; the increases in exports and the efficient import substitution accomplished by many countries in the early 1980s testify to that conclusion.

77. For Latin America, the two alternative financing gaps presented in table 3 reflect an attempt to capture these more complex effects of external debt. One is calculated on the implicit assumption that domestic saving is available in sufficient amount to finance needed investment; all that are required are imports. In the savings-constrained estimates, external finance is necessary to finance increased investment that otherwise would not be possible because of the drain of external interest payments. The principal difference between these different methodologies is the limited role higher rates of export growth can play in facilitating recovery when growth is saving-constrained. In the favourable scenario, financial requirements under constrained savings change very little (and only because of lower interest rates). In the event of saving-constrained growth, exports are not a substitute for finance. That is another reason to question the wisdom of relying exclusively upon an enhanced OECD growth fully to resolve the problem of adequate capital flows.

78. Another point to note in the favourable scenario, whether import or saving-constrained, is the relatively larger Latin American needs, compared to other countries. The reason is because lower oil prices severely affect Mexico, Peru and Venezuela. Even with accelerated OECD growth, it would be necessary to allocate virtually the same level of finance to the region, since that growth is partially at the expense of those countries. It is not only the global amount of finance available to developing countries that counts, but who can get it. To assume that Latin American countries will sustain their trade surpluses and low growth while the rest of the world expands reflects a lack of political realism.

79. For these Latin American countries, then, some \$20 to \$25 billions (in 1985 dollars) in finance will be needed in 1990, a sum that is relatively invariant to scenario or the assumed constraint. Such debt can be absorbed consistent with declining debt/export ratios through 1990. But these large debtors will have to reduce their import requirements and increase their exports and domestic-saving capacity. They will need to make those structural adjustments if they are to continue to grow in the 1990s without an undue dependence on foreign capital that

could check declines in debt-export ratios and send current account deficits to intolerable levels. The finance levels of table 3 in 1995 imply virtually constant debt-export ratios, and at levels too high for comfort.

80. These countries are quintessentially the ones that need finance now to promote structural adjustment to reduce later requirements. With the decline in oil prices, that becomes especially true of the oil-exporting countries in the region.

3. The large Asian countries

81. China and a large part of the Indian subcontinent have been the development successes of the 1980s. Unburdened by extensive debt and less adversely affected by the external environment than the other developing countries, their per capita growth rates have accelerated in 1980-1985.

82. The special challenge they present lies in the sheer magnitude of resources they can usefully and productively absorb as they seek to sustain rapid rates of development. China alone, according to its new economic plan, could absorb capital inflows of around \$8 billion per year by 1990 as increased investment requires imports and external finance. Because of those countries' favourable performance and their limited initial debt, their needs are sometimes simply left to the private sector to fill.

83. For the large Asian countries, table 3 indicates financing requirements of an order of \$10 to \$15 billion (in 1985 dollars) in 1990, and as much as \$20 billion (in 1985 dollars) in 1995. Even on the assumption that those countries will absorb one third of the currently projected total official bilateral and multilateral lending, they face a large need for private finance. The questions are whether even they will find it in the changed capital markets of the late 1980s and, even if they could, should their development be financed in that fashion?

84. To assume that the gap will be filled by private finance may be to entice those countries onto a path that has already proved dangerous for others that have preceded them. It is to ignore the potential costs of variable interest rates which assume that borrowers, rather than lenders, must bear the entire macro-economic risk. It is to disregard the vulnerability of medium-term finance for development projects with a long pay-off period. And it is to forget the lesson of the unreliability of private capital supply.

85. The fact that these countries were spared the scars of the last debt crisis is no reason to expose them to a potential next one. The present patterns of official lending imply that, by 1990, they will be raising well over half their development finance from private rather than official sources. This is clearly unacceptable. These low-income countries continue to require to a large extent access to official financing. Their premature graduation, and their inherent conservatism, will result in unnecessarily lower growth rates, and less integration than desirable into the international economy.

D. The special needs of sub-Saharan Africa

86. Although sub-Saharan African countries rely largely on official concessional finance, their indebtedness has deepened, with debt-servicing now averaging more than 30 per cent of exports and becoming increasingly unmanageable. Indeed, while debt and debt-servicing and their implications for financial requirements are much larger in aggregate terms for the major indebted countries, the economic indicators show even more serious problems for sub-Saharan Africa.

87. Sub-Saharan Africa has been experiencing falling per capita incomes for over a decade. This alarming trend has recently accelerated and, for the period 1980-1986, per capita output has declined by about 12 per cent. Low-income Africa is now poorer than in 1960 and the World Bank forecasts a further decline in per capita income over the next 10 years. Food production and health and education facilities are all undergoing longer-term deterioration with rapid population expansion seriously aggravating the situation. It is important to note, however, that the region's performance has not been uniformly poor. Africa also has its development successes with some countries achieving a record of sustained growth in the last two decades which compares favourably with the average for developing countries.

88. While economic problems differ in nature and depth in the various countries, the capital-resources constraint is a major general problem in the current development crisis in sub-Saharan Africa.

89. A sharp decline in domestic and foreign resources available for investment means that rehabilitation is not keeping pace with depletion in the already meagre capital stock, including basic facilities and infrastructure. Between 1980 and 1984, domestic investment fell from almost 23 per cent of GDP to 14.5 per cent. An interesting comparison is with South Asia, where a comparable rate of investment in 1980 has been largely maintained.

90. For a region with the highest dependence on commodity exports, depressed commodity prices, unrelieved by the recovery in the industrial countries, have been extremely damaging. Since 1980, the terms of trade have been in almost continuous decline and, between 1980 and 1984, the purchasing power of exports fell by over 27 per cent. At 1977 prices, export earnings in Africa in 1985 would have been \$5 billion higher than they were. Since sub-Saharan Africa is a net exporter of oil, the oil-price decline will not improve the aggregate situation, although individual oil-importing countries will clearly benefit.

91. In addition to the unfavourable terms of trade, increased food imports and interest rates and large debt-service payments have worsened the foreign-exchange shortage. With gross capital flows to the region not increasing, these developments have led to a sharp decline in imports to levels which cannot support a recovery. On current trends, annual imports in 1986-1990 will be 20 per cent below the levels of 1980-1982. With population growing rapidly, the fall in per capita imports has been nearly 40 per cent.

92. Partly as a result of this performance, African Governments have recognized their own responsibilities for reform and are making a major effort to improve their policies. Attention is being paid to such areas as macro-economic policy, deforestation, agricultural research and family planning. Three quarters of African Governments now endorse family planning and have set targets for population growth. The adoption of a variety of hybrid maize has enabled some East African

countries to become self-sufficient in maize production. Much more, however, remains to be done and for many countries the task has scarcely begun. Emphasis must now move from emergency relief to longer-term development with a concentration of scarce capital resources on rehabilitation. These efforts will, however, make little progress unless supported and encouraged by expanded external-resource flows and improved terms of trade.

93. With the stagnation in official development assistance (ODA), the decline in private flows and the large increases in debt-service payments, sub-Saharan Africa is experiencing a steep decline in the net transfer of resources. This stands in stark contrast to the positive response of the public in donor countries to emergency needs and the unprecedented willingness of the African Governments to accept donors' guidance and advice.

94. Recent estimates of capital requirements for sub-Saharan Africa made on modest assumptions show financing short falls during 1986-1990 of the order of \$6 billion a year for the sub-Saharan countries, of which almost one third must come from concessional lending. The best estimates by the World Bank for low-income Africa shows an annual gap of \$2.5 billion in concessional finance for the period 1986-1990 between the resources required and those which are in prospect. 7/

95. These calculations indicate the major effort that is required to expand official flows. For low-income Africa, unlike some countries in Latin America, further commercial borrowing is neither feasible nor financially responsible. The urgent requirement is for a large increase in concessional assistance through a greatly expanded International Development Association (IDA), and increased bilateral assistance, including the wider adoption of debt relief and increased support for export credit. But more is required. A new kind of compact between African countries and donor Governments must seek a much more ambitious combination of policy reforms and financial flows.

96. On the donors' side, a first and crucial step will be securing an Eighth IDA Replenishment, which is enlarged in real terms beyond the current provision for IDA and the Special Facility for sub-Saharan Africa. At the bilateral level, further assistance can be provided in a number of ways. Some creditor developed countries have already implemented the terms of United Nations Conference on Trade and Development resolution 165 (S-IX) of 11 March 1978, section A of which provides for retroactive terms adjustment (RTA) in respect of past aid. 8/ Where full implementation has proved difficult, there must be action to ensure that debts are made repayable in local currency or on highly concessional terms. Some of the poorest countries could benefit substantially from a further extension of RTA. Another option is a moratorium for a reasonable period on the payment of interest and amortization.

97. Donor countries should also enable their export credit agencies to finance rescheduled debt-service payments on concessional terms; they should widen the group of creditors that participate in rescheduling of principal and interest and adopt multi-year rescheduling on a wider basis. They must also increase their bilateral aid budgets, particularly in the form of balance-of-payments support for adjustment programmes.

98. Just as importantly, donors must show greater commitment to improving the quality, as well as the quantity of their aid. They must acknowledge that their own policies on aid, which have usually put the interests of domestic contractors ahead of the needs of the recipient countries, have made a sizeable contribution to

Africa's present hardships. Long-term commitments from donors will be necessary to support the profound structural changes required of African Governments. The short-term nature of much past financial support has hampered the implementation of programmes and has made it difficult for African countries to develop realistic longer-term national development plans. Support and encouragement should be given to develop such plans. Donor pressures for high-profile capital-intensive projects have helped distract African Governments from the crucial importance of agriculture and labour-intensive industries. These pressures must now be reversed.

99. In the Declaration on the Economic Situation in Africa, adopted by the Assembly of Heads of State and Government of the Organization of African Unity at its twenty-first ordinary session 9/ the African Governments clearly recognized the need for individual and collective action in the face of the critical economic situation in Africa. Governments also adopted concrete measures contained in Africa's Priority Programme for Economic Recovery, 1986-1990. 10/

100. The policy changes required concern both economic and social areas. On the economic side, a radical restructuring is necessary which will inevitably hurt established interests; on the social side, major priorities are to reduce the gross inequities evident, especially between rural and urban areas, and to reduce population growth.

101. If Africa's special needs are to be met, new mechanisms must be established for co-ordinating and supporting the transfer of substantial additional resources and to facilitate policy dialogue. The forthcoming special session of the General Assembly provides an opportunity for aid donors and African Governments to reach such understandings in order to accelerate financial support for the period ahead. Specific initiatives on the side of aid donors might include commitments to:

(a) Provide an agreed increase in net inflows of finance over the next five years;

(b) Allow a large proportion of this finance to be programme aid, which can be used for recurrent cost, recurrent maintenance and rehabilitation, instead of new investment in capital projects;

(c) Agree on a set of consistent policy conditions, the objectives of which would be to achieve accelerated and sustainable growth, while protecting vulnerable groups. These policy conditions, once accepted, would serve as an agreed frame within which all major aid flows and conditions would be set.

102. On the side of African Governments, consistent with their own priority programme, these understandings might involve continuing efforts to adopt improved policies both in the short- and medium-term on such matters as support for agriculture and provision of adequate incentives; new forms of industrialization; improvement in macro-economic policies and public sector management, including control of budget deficits and formulation of development plans and programmes; education, training and human-resource development; and population policies. These policy commitments are already included in the OAU Recovery Programme and should be implemented with a sense of urgency.

103. The policy changes required depend on the individual circumstances of each country and on a new relationship between Governments and international financial institutions. New forms of negotiation will be necessary to arrive at mutually acceptable agreements, both in terms of the magnitude and the nature of the financial flows and policy prescriptions.

104. Under normal circumstances it should be the World Bank, not the International Monetary Fund, which takes the lead in policy dialogue with African countries. The Fund's short-term macro-economic perspective is rightly perceived by most African countries as inappropriate to their specific problems. Certainly the rigid linkage between IMF adjustment programmes and the rescheduling of official debts in the Paris Club need to be reconsidered.

105. Policy reform must focus on full involvement and commitment of the recipient country. Independent teams should be appointed, with country representation, and participation from the major donors and independent experts, to arrive at a co-ordinated view of financial needs and policy requirements for each country which wishes to participate.

106. African Governments should demonstrate their determination by taking the lead in establishing improved co-ordination processes at the country level. The United Nations should extend the necessary technical assistance when requested by African Governments.

107. An underlying consensus on policy for development now exists between the African and the donor countries. With adequate financial resources and with political will on both sides, Africa could look forward to a steady recovery and rehabilitation.

E. Towards a co-operative solution

108. An integrated response to the crisis of development finance, designed to promote growth in the developing countries, will require bold action - and some sacrifices - from all the partners in development. But the gains for all parties would rapidly exceed the costs:

(a) The Governments of OECD countries will have to come forward with more development aid and export credits, administered more effectively. Their industries and electorates will, in return, gain from revived world trade and stabilized financial markets;

(b) The multilateral development institutions, led by the World Bank, will have to learn better how to administer programme lending, but will acquire a revitalized and more constructive role in the world economy;

(c) Commercial banks will have to commit themselves to long-term programmes of "involuntary" lending and working with their debtors, but their shareholders will benefit from the greater security of the reduced net cash flows they will receive from the third world in the immediate term;

(d) Developing countries will have to maintain and increase their efforts to reform their policies and institutions, but their populations will gain immediately from greater capital flows, better economic policies and faster growth.

109. The Committee calls for a minimum and co-ordinated action programme to double efforts to secure the finance needed to restore developing-country growth.

110. Based on the central scenario for OECD performance, the current-account deficit of developing countries is projected to be about \$31 billion (in 1985 dollars) larger in 1990 than it was in 1985 (see table 4). Of this incremental financial requirement, around \$6 billion can be reasonably projected to be met through a small rise in official transfers (\$2 billion) and a larger increase in direct foreign investment (\$4 billion). This leaves a capital-needs gap of \$25 billion (in 1985 dollars).

111. Current proposals before the international community recognize the need for additional finance - beyond current projected levels - of about \$17 billion per year - \$13 billion in the Baker initiative and \$3.5 billion to \$5.5 billion needed for sub-Saharan Africa. That will avert the most serious problems. But such a sum will not be enough to restore rates of developing-country growth to a sustainable level, where domestic reform and adjustment can elicit the even larger saving and exports that continuing development will require.

112. Doubling the effort is called for at this time. To do less is to fail to capitalize upon the sacrifices already made by developing countries in recent years. It is to run the risk of continuing frustration and future alienation. The moment is ready for a new integrated response to the crisis of development finance.

Table 4

Closing the financing gap, 1990
(Billions of 1985 dollars)

	Additional financing needs
I. Increase in the current-account deficit of developing countries over the 1985 level	<u>31</u> a/
Less projected increases in flows	6
Official transfers	(2)
Foreign investment	(4)
<u>Gap</u>	<u>25</u>
A. Additional official lending	<u>12</u>
New concessional	(4)
of which, IDA net disbursements	(2)
New non-concessional	(8)
of which, World Bank net disbursements	(6)
B. Commercial banks and private institutions	<u>13</u>
New credits	(3)
Relending interest reflows	(10)
II. Increase in reserve acquisition over 1985	<u>15</u>
A. Additional trade credits from commercial banks	10
B. New SDR allocation to developing countries	5

a/ From tables 2 and 3 (central scenario).

113. Broadly speaking, we propose that net new official lending (including IDA disbursements) should increase above the presently projected annual levels by \$12 billion in 1990, about half the additional requirement. Commercial banks and private institutions would provide larger flows of credit of the order of \$3 billion and aim at a systematic relending of interest reflows of about \$10 billion.

114. If the above resources are forthcoming, and if they are used sensibly by developing countries, they will suffice to cover the additional capital needs. However, a further \$15 billion will be needed to provide additional reserves in support of higher levels of trade. Thus, the minimum programme of action proposed by the Committee envisages that about \$10 billion annually may be forthcoming from commercial banks in the form of new trade credits, backed by reserves, and \$5 billion annually may be made available in the form of selective SDR allocations to developing countries.

115. If the proposed collaborative programme is carried through, by the early 1990s, the credit-worthiness of a number of larger developing countries will have improved to a point where they could make medium-term borrowings on international markets and the system would be under less strain.

116. We are under no illusions. The collaborative programme we propose will be far from easy to achieve. But it can be done. If it is not, the short-term debt crisis will inexorably be transformed into long-term stagnation, rising unemployment and, possibly, default.

117. A more detailed presentation of the minimum programme of action is set forth in the following paragraphs.

1. Governments of industrialized countries

118. An increase in official lending is central to any effective strategy for meeting developing-country capital requirements in the next decade. It is the most direct evidence of continuing industrial-country commitment to the objective of adequate economic development. On a practical level, it also provides assurance to private lenders of regular and increasing capital flows of a significant magnitude.

119. In quantitative terms, the Committee recommends an increase in official lending by 1990 of \$12 billion (in 1985 dollars), which would approximately restore the 1980-1981 level (in 1985 dollars). Beyond 1990, it is reasonable to set a target for the increase in official lending at a rate at least comparable to industrial-country growth. That implies a target of 3 per cent a year in the growth rate of real disbursements.

120. Beyond new commitments to the multilateral institutions and increased bilateral aid, Governments will have to take steps to reactivate trade credit. Export credit guarantees provide a basis for assuring the needed expansion of trade finance. Industrial-country Governments, because developing-country debtors have fallen into arrears, have sometimes been requested to make good on the guarantees while the debts have been rescheduled at the Paris Club. Faced with these losses, which show up in the budgets, there has been a reluctance to sustain growth in new guarantee authority. Not only is an increase in guarantee authority necessary, but

it cannot become simply a vehicle for indiscriminate pushing of exports. Greater co-ordination among donors is needed - particularly among donors to the poorest countries, where abuse has been greatest.

2. Multilateral financial institutions

121. The multilateral-lending institutions should be the principal source of official-lending increases. Of the proposed \$12 billion increase in official lending, \$8 billion must come from the World Bank and the regional development banks, and \$2 billion IDA. The cost to the taxpayers of the industrial countries would be minimal if lending were primarily directed through the multilateral banks - whether by additional capital commitments or through increases in their present conservative 1:1 gearing ratio. These agencies rely largely on private-capital markets for the funds which they relend to developing countries. Their non-concessional lending should not be viewed as a form of aid, but rather as an efficient form of intermediation between private-capital markets and developing countries. Their diversified portfolios and privileged repayment position make them preferred credit risks compared to the countries to which they lend. Thus expanded lending by the World Bank and regional development banks provides a natural way of satisfying the requirements of developing countries and private financial investors alike.

122. A special need is for expanded real resources for the poorest countries, particularly the low-income countries of sub-Saharan Africa, whose desperate situation calls for increased concessional finance in addition to debt relief. Of particular importance in this connection is an enlarged Eighth IDA Replenishment beyond the resources now available to IDA and the Special Facility for Sub-Saharan Africa. This need will imply modest - \$2 billion per year - additional claims on the budgets of the industrialized countries.

123. A new allocation of SDRs to the developing countries is also indicated. A large component of developing-country financial requirements is the need for additional international reserves in support of growing trade. Reserve requirements will increase by around \$17 billion (in 1985 dollars) in 1990. The SDR system was designed to facilitate reserve acquisition without expenditure of real resources. In conditions of international financial stringency, and with prospective smaller United States deficits, there is ample justification for a controlled expansion of international liquidity. It would be reasonable to expect developing countries to finance about a quarter of their reserve acquisitions - say \$5 billion - in this way and so be able to utilize more of their hard-earned foreign exchange for needed imports (see table 4).

124. Qualitative changes in lending are also in order. The compensatory financing facility of the International Monetary Fund should be extended to encompass not only variability in export prices, but also in interest rates. Because of accumulated debt, the latter now are an important source of instability. Compensatory finance would provide counter-cyclical lending exactly when borrowers most need it - when unexpected changes in market conditions cause private lenders to revise downward their supply of credit as countries face liquidity problems provoked by higher interest rates.

125. Another requirement is a larger and sustained commitment to macro-economic programme-lending from the World Bank and the regional banks. Project lending, while it can be highly useful in increasing efficiency and providing micro-economic

policy guidance, is slow disbursing and does not always cohere in an overall strategy. More explicit attention to structural adjustment lending will improve the prospects for meaningful discussions of domestic policy. A medium-term focus will impel countries to develop and specify their own strategies and facilitate the necessary dialogue.

3. Commercial banks

126. What remains to meet the incremental current-account financing need of \$28 billion (1985 dollars) annually by 1990 is a level of increased net new private lending per annum of an order of \$15 billion. Debt service provides one critical linkage to assure the needed resources.

127. Interest payments are now the largest component of developing-country current-account deficits. Drastic reduction in new finance make honouring past commitments extremely difficult. That is why commercial banks and other private sources cannot simply withdraw from the international capital market while expecting to receive fully their interest payments and returns of principal. At the same time, there are very good reasons for seeking a gradual and guaranteed deceleration in commercial banks' lending: a return to the dominant role of the banks in the 1970s is neither possible nor desirable. The goal must be to keep the banks fully engaged in the short term even as they lower their exposure over time. That is exactly what has been done since 1982. It is proposed that a longer-term commitment to relend a part of interest reflows be institutionalized as a way of meeting the incremental financial needs of developing countries.

128. That is not the only role for the banks. They have a crucial importance in providing short-term credits in support of trade. With large increases in trade not only anticipated but necessary, supporting trade credit is both productive and limited in risk. As reserve requirements increase in proportion to trade, bank credit should be a principal source of finance for developing countries' increases in reserve holdings. However, trade credit should be primarily viewed as a means of meeting a country's gross financing needs, including reserve acquisition (in addition to SDRs), rather than of offsetting current-account deficits and providing new external resources for investment.

129. The contribution of additional voluntary trade finance is likely to be of an order of not more than \$10 billion (in 1985 dollars). That will approximately restore the relationship to the level of imports characteristic of the early 1980s. It will not go far enough to meet total financing needs. While there will be other increases in voluntary bank lending, including co-financing with official multilateral banks, as well as loans to private clients, including branches of transnational corporations, these will not add much in the aggregate to private financial flows.

130. If developing countries are to be able to enjoy adequate levels of imports and to reduce their transfer of resources, banks will have to do more than finance trade. Involuntary lending will have to be institutionalized in some fashion, assuring the availability of new resources with the same degree of longer-term certainty that applies to the interest flow from developing countries to banks. This commitment can be termed capitalization of interest, because some agreed portion of payment due is automatically postponed to the future, or can be called new lending guaranteed in advance. The precise terminology is of lesser importance than the determination to achieve the desired net result.

131. A virtue of the explicit capitalization approach is that it directs resources to indebted countries in proportion to their debt-service burden and involves all banks in proportion to their present commitments (see box 4).

132. Private incentives alone will not suffice to assure reflows of interest payments. For any individual bank, it is better to be paid in full, and regulatory treatment of accrued interest is a formidable barrier. There will have to be some co-operative arrangement to achieve this goal and one that must necessarily include national government and the official multilateral agencies.

133. The right offset to interest payments, in order to permit the right level of external saving, is not a fixed amount. Nor will it be automatic. It is dependent not only upon the level of official lending, but the full array of domestic macro-economic policies. A broader vision and longer horizon will be necessary in future debt restructurings, and it will have to be one directed more to the viability of developing-country growth than to an exclusive concern for a full flow of payments.

134. The official multilateral agencies are the obvious choice for the role of co-ordination in the debt restructuring which will be necessary. But national Governments will also have to act to induce their banking systems to accept new arrangements, obviously in some joint fashion. The commercial bank exposure problem is not uniquely an American or Japanese or European problem. United States banks hold only a third of the commercial-bank loans even to Latin America. Capital markets have indeed become internationalized, while bank regulation and government co-ordination have lagged behind.

135. Should banks make such concessions before capital flight is reversed? Some have pointed to outflows as a reason for not doing more. But that is a vicious and unproductive circle. In the short term, repatriation of capital is unlikely to be a significant source of finance. To wait for it is to perpetuate the conditions that contributed to capital outflow. The best hope is to restore economic growth and stable, profitable environment for domestic application of resources. That, in turn, requires an appropriate contribution from the banks, along with the right domestic policies.

136. In the end, the banks, as well as the debtors, should benefit from a move to extend debt restructuring. Any new arrangement will need to defend the financial integrity of the banks and recognize that they have not gone scot-free, as market evaluation of their securities and their higher cost of capital attest. It should also be clear that large write-offs of debt are not necessary. The largest countries are ultimately determined to meet their obligations, as confirmed by their dramatic adjustments in the last few years. The problem has been one of market overshooting. With banks too reluctant to lend, countries have been forced to over-adjust. An effort is needed to establish a better balance.

Interest capitalization

Capitalization of interest is a form of interest-payment financing that has several advantages. First, it allots the financial commitments in proportion to the exposure of each lending institution, something difficult to achieve by other means as small creditors have strong incentives to "disengage" during a crisis. Second, it distributes benefits among debtors in proportion to their debts. Third, it provides a simple mechanism for debt relief when interest is capitalized at below the market rate. Fourth, the capital loss sustained by creditors that provide relief can be distributed over time, therefore diminishing the impact of relief on their asset positions. In addition, capitalization allows the burden of relief to be shared between creditors and other interested institutions.

Only if market interest rates returned to the high real levels of the recent past, would capitalization on a general basis be required on below-market terms. Then, there might have to be a partial writing off of the debt - as is now being called for in sub-Saharan Africa. But that is not an immediate prospect. In a co-operative solution, the sharing of the burden for those losses would be a natural and legitimate subject for negotiation between banks, developing countries and the Governments of creditor nations.

From a systemic point of view, certain forms of capitalization may work as a form of built-in stabilizer of interest-rate shocks, as interest-payments fluctuation could be smoothed out or eliminated. A capitalization, or automatic refinancing, scheme operating as part of the international monetary system, with rates applicable to the capitalized amounts, which reflected long-term average tendencies rather than short-term interest rates peaks, could operate in this way.

Various capitalization rules have been suggested. One would keep the real value of outstanding bank exposure constant. That would mean capitalization equal to the rate of inflation. Alternatively, a "cap" to payments can be set at the long-term real rate of interest; any excess would be postponed. Still a third would involve an automatic postponement based on decline in export income due to causes outside the control of the debtor.

Numerous other ways of institutionalizing involuntary bank lending have been suggested. Multi-year new money facilities, an idea recently discussed by the Morgan Guaranty Trust Company, is one alternative which would avoid the regulatory problems which capitalization might face in the United States. Whether it would be easier for the United States to change their regulations or for the banks to organize internationally compatible methods of advancing new money on a long-term basis is of limited importance. What matters is the principle of any such scheme - the banks must commit themselves in advance to relending part of the interest payments which will be due each year from the debtor nations provided, of course, that individual countries follow sound policies.

Partial deferment or relending on a systematic basis of accrued interest leaves intact the incentives for countries to pay appropriate attention to correct exchange-rate and export-promotion strategies. Relief is significant, but temporary. Appropriate exchange-rate and trade policies will still have priority.

4. Developing countries

137. Whatever the banks and official lenders can be induced to contribute, it is clear that country conditionality will have to be a prominent feature of arrangements to enlarge flows during the next few years. Improved developing-country performance is the only guarantor of the capacity to repay the new finance.

138. Conditionality is a sensitive subject, because it impinges on sovereign policy. But the issue is relative, not absolute. No nation enjoys full sway over its economic circumstances in an interdependent international economy. The question is how much of a role there needs to be for external evaluation, and what form this should take in return for the provision of what resources.

139. International Monetary Fund conditionality has evoked strong and negative response, because it has been so strongly weighted by immediate stabilization objectives. Many countries have been kept on a short leash, which has prevented them from undertaking fully coherent strategies that give equal weight to domestic as well as external imbalances.

140. The kind of "conditionality" proposed by the Baker initiative recognizes the need for longer-time adjustment and the priority of growth, but it too may be inappropriate in some contexts. Excessive dependence upon universal prescriptions rather than a willingness to analyse each case on its own terms must be avoided. There is general agreement, for example, on the need to strengthen enterprise efficiency and promote decentralization, but this does not add up to the same style of privatization everywhere.

141. What is needed is a new form of "growth conditionality", with greater participation of the debtor countries in specifying and evaluating longer-term strategies tailored to particular cases. That was a central feature of the European Recovery Plan in the immediate post-war period, and one that was later incorporated in the Alliance for Progress. The call for an expanded role for the World Bank would logically give that institution a more important say in working out acceptable and implementable agreements. As official long-term resources again became the largest source of voluntary lending, this would be a natural development.

142. The objective of a new conditionality should be to bring about a consensus between the various partners in development finance. It requires agreement on policies necessary to "condition" the acts of one on the other. This consensus is essential to ensure that the actions of all parties are directed towards the attainment of their objectives in a non-conflicting manner. Such conditionality will promote growth through an emphasis on the expansion of the supply of finance and the creation of a longer time horizon for adjustment. For the success of the medium-term plans formulated on the basis of this kind of conditionality, there will be need for a mechanism by which the partners can be brought together quickly to re-evaluate their plans in the context of unforeseen economic developments.

143. Conditionality of this kind will be seen as a fairer sharing of the burden than conditionality, whose apparent consequence is service of external debt at the expense of other objectives. It will work to the advantage of countries rather than against them, and will be understood as a reasonable quid pro quo in return for significant benefits.

144. In the last analysis, finance is not a panacea. It must be used for adjustment, not in lieu of it. There is a growing recognition by developing countries of their need to adopt appropriate economic strategies. The combination of expanded finance and growth-oriented conditionality can elicit an appropriate engagement of developing countries.

5. The global framework

145. All these policy reforms can only be successful in a growing international economy. The responsibility of the industrialized countries to achieve a better balanced and faster growth path would not by any means be reduced. Exchange rates have started heading in the right direction, but have not yet been accompanied by fundamental changes in the United States budget deficit. Real interest rates remain at high levels compared to historical experience and anticipated growth rates. The United States as a debtor nation continues to absorb a volume of the world's saving that could more naturally be reallocated to the developing countries. The new oil shock may direct further savings to countries which are already in surplus. The trend towards international policy co-ordination based on shared responsibility remains rudimentary.

146. Our proposal for development finance and growth conditionality does not obviate the need for better OECD performance. Rather they put it in appropriate perspective as one of the elements necessary for the resolution of the problem of inadequate capital flow to the developing world. In the absence of expanding export markets, finance will not be a satisfactory solution even if it becomes available. In turn, improved conditions of capital supply can have positive feed-back on the prospects for OECD economic expansion. Greater finance alleviates the present pressure on the international trading system emanating from the unnaturally large export surpluses of the developing countries. Larger markets of developing countries will stimulate recovery of industrial sectors and employment in the United States and Europe. More rapid and regular expansion of the developing countries will also attract a larger share of the surplus saving of Japan and divert it from excessive underwriting of United States public deficits.

147. The capital needs of developing countries are a global problem and not theirs alone. The ramifications extend beyond the immediate stability of the international banking system and the potential adverse effects of a financial crisis. They touch trading relationships and the changing division of labour not only between the industrial and industrializing countries, but among the OECD countries themselves. What is at stake is the structure of economic interdependence and the liberal system that has underwritten record economic growth in the post-war period.

148. It is up to the industrial countries to act. The multilateral agencies alone cannot take the initiative. The banks are passive participants. The developing countries must set out long-term goals and investment programmes and offer their co-operation, but they cannot lead, except negatively by provoking a crisis. Secretary Baker's initial instincts to address the debt problem were the right ones. Now is the time to go one step further and take on the development challenge.

III. THE WORLD ECONOMIC SITUATION AND PROSPECTS

A. The global outlook

1. A new complacency: reasons and dangers

149. Growth in production in the world economy slackened in 1985 after the significant recovery of 1984. A slightly better performance is expected in 1986 and 1987 (see table 1 above).

150. Growth in the developing world was weak, reflecting the severity of the financial constraints in the medium- and small-sized countries. As many as half of the developing countries experienced zero or negative growth rates in real GDP per head in 1985 (see annex, table A1); this number would certainly be higher if the deterioration in their terms of trade and net outflow of foreign capital were taken into account in the definition of national income. Excluding countries with large populations, such as Brazil and India, whose output expanded rapidly in 1985, the average GDP per head of developing countries declined in 1985 for the fifth consecutive year (see annex, table A2). In sub-Saharan Africa, national income per head was actually lower than 15 years earlier.

151. No dramatic change can be expected in 1986. The fall in oil prices should benefit oil-importing countries, but it will not alleviate the very tight financial conditions they face, while the economies of oil-exporting countries will be seriously affected. Most developing countries will continue to be confined to a low-growth path.

152. In developed market economies, on the other hand, some improvement in growth performance is likely in 1986 with a further decline in inflation following the sharp fall in oil prices and lower interest rates. OECD growth is expected to rise by half a percentage point.

153. Expansion in the centrally planned economies is unlikely to change, at least in the short term. Their Governments, particularly in Eastern Europe, plan to continue the process of economic adjustment. This will involve closer co-operation with each other in the areas of science and technology, industrial production and trade, with a view to accelerating their economic growth by 1990. The Union of Soviet Socialist Republics is planning a sharp expansion of investment and output in certain sectors, particularly machinery. Chinese policy-makers, however, are determined to moderating the recent rapid pace of economic growth in order to correct imbalances that have emerged in several areas and to carry out a package of industrial reforms.

154. Growth in international trade is expected to remain modest in 1986 and 1987 (4.0 per cent to 4.5 per cent). The demand for imports will continue to be restrained by moderate growth in world output and the financial difficulties of many countries. Under those conditions, although the situation of individual debtor countries differs significantly, debt-servicing could become more irregular and strains on the international financial system could increase.

155. Income per head in developed market economies as a whole has increased at an annual rate of about 2 per cent in the last three years. This increase has been widespread, albeit uneven, and it is likely to be maintained in 1986 and 1987. None the less there is still significant underutilization of capacity in some

countries. Labour markets and markets for most primary commodities are also weak and are likely to remain so in the near future.

156. The rapid recovery of aggregate demand in 1983 and 1984 did not lead to overinvestment in fixed capital assets in some sectors or to excessive accumulation of inventories, as in past cycles. Instead, investment levels are expected to be maintained, as falling interest rates are reinforced by further increases in consumption. Consumption growth should be promoted by the wealth effects from the marked rise in stock and bond prices in virtually all industrialized countries, by the recent increases in real disposable incomes and by expectations of low inflation rates.

157. In early 1985, the substantial overvaluation of the dollar was a major source of concern. But the effective dollar exchange rate has fallen by 30 per cent from its peak in March, largely due to the agreements reached by the Group of Five 11/ in September 1985. This sharp decline has temporarily allayed fears of an upsurge in United States protectionism. The decision by the Contracting Parties to GATT in November 1985 to start preparations for a new round of trade negotiations should encourage resistance to protectionist pressures in other countries.

158. The above factors give the Governments of most developed countries room to continue the long-term policy objectives that they set themselves in the late 1970s and early 1980s, including structural adjustment and a substantial slowdown in the growth of non-defence government expenditure.

159. There is still insufficient evidence to assess the extent of industrial restructuring that has taken place in the last few years. None the less, underlying trends suggest that it is proceeding at a significant pace. There has been a substantial expansion of output in high technology industries, while traditional industries continue to shrink in relative, and often absolute, terms. The increased efforts by developed economies since the mid-1970s to save raw materials and particularly to conserve and substitute energy have led to changes in product design and, sometimes, in the product mix. The use of raw materials, and particularly oil, per unit of final output has declined at a faster pace than in the past. 12/ Thus the rather slow overall growth of developed market economies has not prevented the majority of them from undertaking a good deal of structural adjustment. Moreover, the growth rate envisaged for the next two years should allow them to continue the restructuring process.

160. Most industrial countries have also experienced a substantial reduction in the growth of public spending. With few exceptions - the main one being the United States, and there changes have already been legislated - the fiscal deficit as a share of GNP has decreased and, in some countries, the full employment adjusted fiscal balance is showing a significant surplus. Present Governments in most developed market economies welcome this development in the belief that there will be sufficient stimulus from the private sector. It is therefore unlikely that they will alter their fiscal policies substantially in the near future.

161. The above developments have led many policy-makers to a somewhat complacent view of world economic prospects. In several respects, however, the world economy remains vulnerable. The financial system is still fragile. The continuing very high rates of youth unemployment may gradually erode the social fabric in some countries. A solution to the external debt problem is definitely not in sight; in most debtor countries, debt-service ratios resumed their upward path in 1985 after having declined somewhat in 1984. Nominal interest rates have declined sharply,

but remain high in real terms, thus discouraging investment in many parts of the world. Commodity markets and exchange rates remain very volatile, with lower oil prices adding a new element of uncertainty to the functioning of financial markets. More important, there is the danger that slow growth in the developing economies will persist and that the drag they presently exert on the world economy will become entrenched.

162. Thus the world economy faces significant downside risks. This is particularly relevant to most developing countries, which will continue to experience very slow economic growth or outright stagnation. Their domestic efforts need to be supported by a substantially improved international economic environment. In particular, there is a need for more dynamic international trade, lower real interest rates and substantially higher international financial flows for development. Current trends suggest that the expansion in international trade will be too weak to facilitate debt-servicing or to lead to a recovery in primary commodity prices. While the growth rates envisaged for developed economies may appear adequate to their own policy-makers, they are clearly insufficient to pull developing countries out of this trough.

2. Reducing the fiscal deficit in the United States

163. For the United States, a reduction in the fiscal deficit is necessary to achieve lower real interest rates, to prevent interest payments on government debt from becoming explosive and to lessen uncertainties in financial markets (international as well as domestic). However, the timing and particularly the size of the reduction could have adverse short-term consequences for the world economy. The United States federal deficit reached \$212 billion in 1985 and is expected to be around \$200 billion in 1986. The legislation recently passed by Congress (Balanced Budget and Emergency Deficit Control Act of 1985), if strictly implemented, should lead to a cut in government spending of some \$45 billion in the coming fiscal year.

164. A cut of such magnitude implies a sizeable decrease in aggregate demand. It is about half the increase in the United States fiscal deficit in 1983, which provided a critical impetus for the 1983-1984 upturn in industrial countries. Unless it is offset by a comparable increase in real purchasing power in Europe and Japan, a slow-down in the world economy is a distinct possibility in 1987.

3. Payments imbalances

165. The recent fall in oil prices will affect the pattern of current-account balances among countries. The reduction in the oil import bill should widen further the already large current-account surpluses of several industrial countries. Rough estimates (based on a crude oil price of \$18 per barrel) indicate a \$15 billion saving in Japan and a \$30 billion savings in the oil-importing countries of Western Europe. Unless there is smooth recycling of this windfall, particularly to counteract the likely cutback in the imports of oil-exporting countries, world trade, and the trade of developing countries as a whole, will be adversely affected.

166. The transfer of resources from debtor developing countries to financial centres is another source of global instability. Since 1983, interest-payment outflows in many developing countries have exceeded by a considerable margin

net-capital inflows. Until recently, it was hoped that this reverse resource transfer would be a temporary phenomenon and that, as interest rates fell, exports would grow rapidly and debtor countries would regain credit-worthiness. But those expectations have not been fulfilled and the reverse transfer of resources appears more permanent. Some debtor countries might be able to make such a transfer for a few more years, but, for the majority, a reverse transfer of the present magnitude seems unsustainable in the long term. In particular, it implies a reduction in national income and lower saving and investment levels and, therefore, the capacity for growth.

4. The implications of sluggish world trade for debt-servicing and primary commodity exports

167. Except for the spurt in 1984, the growth of international trade since 1980 has been sluggish. Four largely interrelated factors explain the weak increase in trade volumes since the late 1970s: the slowdown of growth in world output; protectionist measures; the repercussions of increasing strains in the international financial system on the trade system; and the efforts of energy-importing countries to conserve energy and substitute domestic energy sources for fuel imports.

168. World output increased at an annual rate of only 2.7 per cent in the first half of the 1980s, which is well below the annual average rate of growth in the preceding two decades and insufficient to give much stimulus to world trade. Trade has also been affected by a variety of restrictions; protectionist actions in the 1980s have outweighed new liberalization measures. Since 1982, the international trading system has also absorbed a large share of the adjustment required by the financial difficulties of debtor countries. The volume of imports of the 10 largest Latin American debtors fell by almost 40 per cent between 1980 and 1985. Furthermore, energy conservation efforts led to an actual drop in oil consumption in the 1980s and, consequently, to a fall in oil exports.

169. The factors behind the slow-down of world trade in the first half of the 1980s are likely to persist in the second half, although with different degrees of intensity. Current trends indicate an annual growth in the volume of world trade of under 4 per cent in 1986 and 1987.

170. Unless international trade grows much faster than presently envisaged, debt-servicing difficulties are likely to persist despite the substantial adjustments that most debtor countries have already undertaken. For several countries, such efforts may appear to have been futile, and many more may therefore decide to limit the amounts of funds to be transferred abroad in debt service. International financial markets could be shaken again.

171. The expected output and trade trends are unlikely to lead to the kind of recovery in primary commodity prices that would improve the situation of the more vulnerable countries. During most of 1985 primary commodity markets remained weak. Non-oil commodity prices, after having fallen by some 10 per cent in 1985, are still some 20 per cent below their 1980 levels (in dollar terms). Around 70 developing countries depend on primary commodities for over half their export earnings. Weak or falling commodity prices are therefore likely to restrain any growth in their imports.

172. In this respect, the situation of countries in sub-Saharan Africa is extremely serious. By late 1985, half of those countries had barely enough reserves to finance one month of imports and a third had only enough for two months' imports. Moreover, in many of those countries, arrears on external payments significantly exceeded the level of reserves. Despite considerable improvements in agricultural and food production in many sub-Saharan countries of Africa in 1985, the need for imports and food aid remains substantial. Unless their balance of payments improves, most countries in that region will be vulnerable to widespread hunger if weather conditions deteriorate again.

173. There is significant uncertainty about the extent to which primary commodity markets might strengthen in 1986. For most of these commodities, dollar prices are likely to inch upwards, but not much of an improvement is expected in terms of SDRs. For developing countries as a whole, the terms of trade will probably worsen in 1986, energy-exporting countries experiencing a fall of more than 40 per cent.

174. Compared to other primary commodities, oil prices were fairly stable in the first half of the 1980s, as a result of OPEC members' reduction of output and exports to balance world supply and demand. However, a considerable fall in the OPEC share of the international fuel market led to some of the largest producers reversing this policy in the latter part of 1985. Subsequently, oil prices have become more volatile with excess supply leading to a substantial plunge. While the level of international reserves held by several oil-exporting countries can cushion this sudden fall, for many - large debtors in particular - a continuation of lower prices in the months ahead will definitely cause serious balance-of-payments difficulties.

B. Towards an improved world economic environment:
selected policy issues

175. In many aspects the world economy remains fragile and there is danger of slow growth becoming permanently entrenched in many parts of the world.

176. Recent developments, however, indicate that there is more room for manoeuvre. As risks of higher inflation in industrial countries have lessened, there is a case for more active policies. Such policies could speed up the correction of global disequilibria and give a further stimulus to economic growth. The latter is indispensable to reverse the sluggishness in international trade which has been seen since 1980.

177. While policy-makers in some key economies see a need for some caution, there is increasing recognition that problems are interrelated and that, in several areas, multilateral approaches might be more effective. Growing interdependence and the relationships among issues underline the importance of taking due account of policy linkages when devising solutions. Enhanced co-ordination among the main actors to improve their own policy mix is important to achieve stronger non-inflationary growth throughout the world economy. But more comprehensive efforts with a wider participation of other countries are also needed to discuss the formulation of policies that have international implications.

178. The rather cautious stance in industrial countries is partly explained by the fact that cyclical patterns seem to have changed and that the underlying relations among critical variables - that is, interest rates, the money stock, inflation, investment, government expenditure and output - are not as clear-cut as they

appeared to be in the past. Since the late 1970s, policy-makers in various countries have gradually shifted their attention from demand management to supply-side considerations. Moreover, in many productive sectors as well as in functional areas, adjustments seem to be taking place in the desired direction through the interplay of market forces.

179. However, market solutions in some cases do not seem to be working effectively, much less restoring equilibrium. The present pattern of the recycling of global savings, if continued, could lead to increasing disequilibria. The persistence of the difficulties of debtor countries also shows that current approaches to the debt problem are not working effectively and that, as recognized in the Baker initiative, a more comprehensive policy package is required. There might be a case for a more gradual - or stage-by-stage - approach to certain problems, but there is no case for hesitation in adopting the set of measures required to correct global disequilibria and promptly accelerate growth in the North while restoring development in the South.

180. A larger measure of stability and, in particular, a further reduction of interest rates, are necessary to strengthen the current expansion, promote investment, consolidate gains in the fight against inflation and lessen financial strains. The weakening of inflationary pressures, partly due to lower energy prices, and the likely reduction of the United States fiscal deficit, provide an unusual opportunity for more active monetary policies geared to a reduction in interest rates.

181. While a lower fiscal deficit in the United States should facilitate a gradual adjustment of the current-account imbalances among the large countries, it will not per se prevent destabilizing movements in exchange rates. Thus, it is important to co-ordinate monetary policies to achieve gradually a pattern of interest rates among reserve-currency countries that would lead to a smooth correction of the overvaluation of the dollar. The meeting of the Group of Five in September 1985 proved that mutually supportive action, such as joint intervention or monetary policy co-ordination, can be effective in achieving the desired results in a speedy manner. A consolidation of such efforts is critical, and it is also important to initiate a process of improving the international monetary system with the participation, and for the benefit, of all countries.

182. Given the critical link between the debt problem, interest rates and aggregate demand in developed market economies, the above policies would be an important step towards normalizing debt-servicing and fostering development. However, they might not be sufficient. Debtor countries have to expand their export capacity and therefore require a rapid rather than a moderate growth in world import demand.

183. The lessons of the last 10 years indicate that excessive dependency on borrowed external capital is often harmful. There is a need in most developing countries to strengthen or reformulate financial policies in order to increase national savings. It is true that the room for manoeuvre in this area is limited, particularly in countries in which national income has shrunk sharply. A dramatic turnaround in the saving rate, albeit desirable, will be difficult to achieve in a short period. However, it is crucial that countries introduce policies to ensure a considerable increase in the rate of private and public savings so that in a reasonable number of years they will be able to finance a high and fairly stable investment rate.

184. In developing countries, a successful external adjustment requires a judicious mix of policies that promote exports and substitute imports in an efficient manner. Without a considerable increase in world import demand, however, external adjustment efforts might take too long to bear fruit and, for some countries, might even be counter-productive. A more robust economic expansion in industrial countries leading to strengthened primary commodity prices should considerably improve the export earnings of developing countries. But concurrent actions to liberalize trade are required. It is important to take full advantage of a new round of multilateral trade negotiations to arrest the drift towards protectionism and set the stage for a more vigorous growth in world trade. Successful negotiations should be for the benefit of all, as an improved trading environment would smooth the long-term adjustments required by industrial and developing countries. But, since a new round will be a long-term process and will produce effects that will only be felt in the long run, prompt action is needed to alter current trends. An immediate reduction of trade barriers is an important ingredient of an early revival of international trade.

IV. IDENTIFICATION OF THE LEAST DEVELOPED AMONG THE DEVELOPING COUNTRIES

185. At its resumed twenty-first session in April 1985, the Committee examined 13/ the cases, inter alia, of Kiribati and Tuvalu with a view to determining their eligibility for inclusion in the list of the least developed countries, but did not reach definite conclusions because of inadequate information on the economies of those countries. The Committee re-examined the cases of those two countries at its present session. In addition, at the request of the General Assembly (resolution 40/219 of 17 December 1985) and the Economic and Social Council (decision 103 of 7 February 1986), the Committee examined the case of Mauritania.

186. Following the practice established in earlier reviews, the Secretariat provided the Committee with the information necessary to update the per capita GDP criterion for changes in prices and the real growth of per capita GDP in world market economies. The adjusted lower and upper cut-off points of the per capita GDP criterion were found to be \$353 and \$423. The Secretariat further supplied the Committee with the most recent available data on per capita GDP, the share of manufacturing output in GDP and the rate of adult literacy for the countries concerned. 14/

187. The Committee reviewed this information as well as the materials submitted by the Governments of the three countries.

188. In brief, the available information revealed the following features of the economies of the three countries:

(a) Kiribati. With a land area of 800 square miles and a population of about 65,000 dispersed over 21 coral atolls over a vast area in the Pacific Ocean, Kiribati is a country that suffers from many relative disadvantages, namely, smallness of size, isolation, fragmentation, lack of natural resources, rudimentary infrastructural facilities and a virtual absence of industry. The labour force is largely unskilled; the adult literacy ratio is estimated at about 14 per cent. Per capita overhead costs of public administration, social-service facilities, and transportation and communication facilities are unusually high because of the dispersal of a small population over several islands widely separated from each other. Isolation of the country from the main markets of its exports and imports make for exorbitantly high transportation costs of its international trade. With the exhaustion of phosphate in 1979, exports and per capita gross domestic product suffered a severe setback. In 1985, per capita income fell to about \$300 from about \$700 in 1979. Kiribati now relies mainly on copra for export earnings. The output of copra is subject to fluctuation because of damage caused by frequent hurricanes. A high proportion of Kiribati's national income accrues to expatriates, who remit a considerable proportion of the salaries they earn abroad. The country is heavily dependent on external assistance.

(b) Tuvalu. A sister island of Kiribati, Tuvalu has similar features and suffers from all of the same relative disadvantages as it is smaller; it suffers even more from the disadvantages of small size. The country has a population of only about 8,400 settled over a land area of 24 square kilometres on 9 coral atolls dispersed over 600 kilometres north to south. The adult literacy ratio is estimated at some 12 per cent. Like Kiribati, Tuvalu relies heavily on copra for export earnings, is located in the cyclonic belt and is fragmented and isolated. The country has a poor natural resource base, rudimentary infrastructure and

virtually no manufacturing industry. Expatriates claim a high proportion of national income, considerable amounts of which are remitted abroad. Per capita income has fallen steadily in recent years from about \$400 in 1985. Like Kiribati, Tuvalu relies heavily on external assistance.

(c) Mauritania. As it is a dry and largely arid country, Mauritania has a very low agricultural potential. Out of a land area of 103.1 million hectares, only 0.7 million hectares are suitable for irrigated crops and some 1.4 million hectares for dry cultures. The population of the country is estimated at some 1.9 million, with an adult literacy ratio of 17 per cent. The country's economic performance has weakened in recent years owing to a prolonged drought and increasing desertification, which has affected agriculture, the major sector in terms of employment. Output of iron ore, the country's major export commodity, has suffered a setback because of depressed demand. The share of industry in gross domestic product has stagnated at an estimated 5 per cent. Per capita income has been on the decline since 1981 from over \$400 to about \$320 in 1985. Substantial public investments financed through grants and concessional loans have not been very productive. The decline of the agricultural sector - both crops and livestock - has necessitated increased reliance on commercial food imports and food aid.

189. From its examination of the available information, the Committee concluded that the three countries met the existing criteria for inclusion in the list of the least developed countries and, accordingly, recommends that they should be added to the list.

V. ARRANGEMENTS FOR FUTURE WORK

190. For its 1987 session, the Committee proposes to consider the topical issue of "adjustment with growth". The objective will be to examine the nature of growth-oriented adjustment policies and programmes and the national and international dimensions of such an adjustment process.

191. Within the general theme of "adjustment with growth", the Committee proposes to explore the prospects for aid donor-recipient relations. The Committee will review conditionality guidelines for donors and recipients, suggest possible modifications in the practice of conditionality and identify mechanisms for the effective resolution of disputes between donors and recipients.

192. Recognizing that people are the ultimate agents and beneficiaries of growth-oriented adjustment programmes, the Committee proposes also to examine the human dimension of the adjustment process. The Committee will review disturbing signs of an acceleration of poverty in the 1980s and identify corrective measures to reverse such trends.

193. The Committee requests the Secretariat to make the necessary arrangements for the preparation of the substantive studies required for an effective consideration by the Committee and its working groups of the "adjustment with growth" theme proposed for next year's session.

194. The Committee further proposes to convene a representative working group of eight members for three days in the first quarter of 1987 in New York to consider the studies submitted by the Secretariat and provide guidelines for the Committee's report. The draft report should be submitted to Committee members in advance of the plenary session, which would be scheduled in the second quarter of 1987.

195. The Committee welcomes the assistance provided by two consultants to the work for the present session and the steps taken to disseminate its report and requests the Secretariat to make similar arrangements in the future.

196. Following past practice, the Committee requests the Secretariat to make arrangements for the presentation of the report to the Economic and Social Council by the Chairman.

197. General Assembly resolution 40/207 of 17 December 1985, on long-term trends in economic development, was brought to the attention of the Committee. The Assembly, inter alia, invites the Committee to review progress in the preparation of the report of the Secretary-General on the subject and the Committee stands ready to advise, as necessary, in the context of its work.

198. The Committee has been informed by the Secretariat that the proposed work programme can be carried out within present budgetary appropriations.

VI. ORGANIZATION OF THE SESSION

199. The twenty-second session of the Committee for Development Planning was held at United Nations Headquarters from 19 to 22 March 1986. The Chairman of the session was Shridath S. Ramphal. Gerasimos Arsenis served as Rapporteur and Jozef Pajestka as Vice-Chairman. Fourteen other members attended the session: Abdlatif Y. AL-HAMAD, Kenneth BERRILL, Bernard CHIDZERO, Just FAALAND, Armin GUTOWSKI, Huan XIANG, Shinichi ICHIMURA, V. N. KIRICHENKO, Robert S. McNAMARA, Joseph E. NGAMPORO, G. O. NWANKWO, Janez STANOVNIK, Mohammad SADLI and Rehman SOBHAN. Six members were unable to attend: Ismail Sabri ABDALLA, Jean-Pierre COT, Hernando de SOTO, Celso FURTADO, I. G. PATEL and Luis A. ROJO. The following invited experts assisted the Committee in its deliberations: Mahbub ul HAQ, Carlos MASSAD and John WILLIAMSON. Albert FISHLOW and Anatole KALETSKY attended as consultants. 15/

200. Prior to opening the session for discussion, the Chairman of the Committee made a statement (see annex II below).

201. The Committee's deliberations were facilitated by the work of its Working Group on Capital Requirements of Developing Countries. The Group met in New York from 9 to 11 December 1985 and its members were: Shridath S. RAMPHAL (Chairman), Joseph PAJESTKA (Vice-Chairman), Gerasimos D. ARSENIS (Rapporteur), Ismail SABRI ABDALLA, Abdlatif Y. AL-HAMAD, Kenneth BERRILL, Just FAALAND, Armin GUTOWSKI, Shinichi ICHIMURA, Robert S. McNAMARA, G. O. NWANKWO, Rehman SOBHAN and Janez STANOVNIK, and the following invited experts: Jagdish BHAGWATI, Ariel BUIRA, Sidney DELL, Albert FISHLOW (consultant) and Anatole KALETSKY (consultant).

Notes

1/ For the report of the Committee on its twenty-first session, see Official Records of the Economic and Social Council, 1985, Supplement No. 9 (E/1985/29). See also the views of the Committee issued under the title Challenge to Multilateralism: A Time for Renewal (United Nations publication, Sales No. E.85.II.C.2).

2/ Economic Commission for Latin America and the Caribbean, "The problem of the external debt: gestation, development crisis and prospects" (LC/G.1406 (SES.21/10 of 6 March 1986)), p. 23.

3/ See Journal of Development Planning, No. 16, particularly the articles by C. Massad, entitled "Debt: an overview", and by R. Dornbusch and S. Fisher, entitled "The world debt problem: origins and prospects".

4/ Even under the pervading new optimism inspired by lower oil prices and interest rates, the April 1986 IMF forecast of GDP growth for capital-importing developing countries for 1986-1991 is now about 4.4 per cent per year compared to the October 1985 forecast of 4.8 per cent.

5/ See ECLAC, "Economic development: an appraisal, and projections 1985-1995" (LC/L.367/CEG.LL/3 of 13 February 1986).

6/ Ibid.

7/ World Bank, Financing Adjustment with Growth in Sub-Saharan Africa, 1986-1990 (February 1986).

8/ Official Records of the General Assembly, Thirty-third Session, Supplement No. 15 (A/33/15), vol. I, part two, annex I.

9/ A/40/666, annex I, document AHG/Decl.1 (XXI).

10/ Ibid.

11/ France, the Federal Republic of Germany, Japan, the United Kingdom of Great Britain and Northern Ireland and the United States of America.

12/ In OECD countries, the ratio of oil consumption to gross national product fell by one third between 1975 and 1985.

13/ As requested by the Economic and Social Council in resolution 1984/58 of 26 July 1984.

14/ See "Identification of the least developed among the developing countries" (CDP/22/4 of 24 February 1986).

Notes (continued)

15/ Substantive services for the session were provided by the Department of International Economic and Social Affairs of the United Nations Secretariat. The Committee was also assisted by representatives of the Office of the Director-General for Development and International Economic Co-operation, the United Nations Centre on Transnational Corporations, the Department of Technical Co-operation for Development, the Economic Commission for Europe, the Economic Commission for Asia and the Pacific, the Economic Commission for Latin America and the Caribbean, the World Food Council, the United Nations Conference on Trade and Development, the United Nations Industrial Development Organization, the United Nations Children's Fund, the United Nations Development Programme, the United Nations Institute for Training and Research, the International Labour Organisation, the Food and Agriculture Organization of the United Nations, the United Nations Educational, Scientific and Cultural Organization, the World Health Organization, the World Bank, the International Monetary Fund, the International Fund for Agricultural Development, the Latin American Economic System and the Commonwealth Secretariat.

Annex I

STATISTICAL TABLES

Table A1. Number of countries with growth rates of real GDP at or below the rate of growth of population, 1979-1985

	Total sample size	1979	1980	1981	1982	1983	1984	1985 <u>a/</u>
World	113	27	40	51	67	60	46	52
Developing economies	83	25	32	38	55	51	45	48
Africa	32	14	15	21	25	21	25	21
Mediterranean	4	0	1	0	0	1	0	0
South and East Asia	14	2	4	0	2	3	1	2
West Asia	10	3	4	5	7	7	8	7
Western hemisphere	23	6	8	12	21	19	11	18
Developed market economies	22	1	6	11	10	8	1	3
Centrally planned economies <u>b/</u>	8	1	2	2	2	1	0	1

Source: Department of International Economic and Social Affairs of the United Nations Secretariat.

a/ Based on preliminary data.

b/ Per capita net material product.

Table A2. Annual rate of increase of gross domestic product in developing countries

(Percentage)

	1976-1980	1981	1982	1983	1984	1985 <u>a/</u>
<u>Gross domestic product</u>						
All developing countries	4.9	1.3	0.2	0.8	2.1	2.5
Developing countries excluding large countries <u>b/</u>	4.5	1.0	-0.6	0.1	1.5	1.4
<u>Per capita gross domestic product</u>						
All developing countries	2.4	-1.0	-2.1	-1.5	-0.2	0.2
Developing countries excluding large countries <u>b/</u>	1.9	-1.5	-3.1	-2.4	-1.0	-1.1

Source: Department of International Economic and Social Affairs of the United Nations Secretariat.

a/ Preliminary estimates.

b/ Countries whose population exceeds 100 million (Brazil, India, Indonesia).

Annex II

STATEMENT BY THE CHAIRMAN OF THE COMMITTEE AT THE OPENING OF ITS TWENTY-SECOND SESSION

The focus of our work for this twenty-second session of the Committee for Development Planning - capital flows to developing countries - could not be more apt. Recession has eased in the industrial world, but development still faces a crisis and at the heart of that crisis now is the inadequacy of capital flows to support policy reform and the long-term capital needs of developing countries. The theme also represents continuity with our recent reports.

The widened recognition that adjustment must be growth-oriented and that the traumas facing sub-Saharan African countries require a major longer-term international effort increase the relevance of our work over the next three days. There is some convergence of views on diagnosis, but limited though it is, it is still to be translated into a commensurate practical effort. Therein lies the challenge for the Committee. Important decisions are in the process of being made which could give effect to evolving perceptions about the need for a more humane and sustainable adjustment and development process. The Eighth IDA Replenishment and the lending programmes of the World Bank and the regional development banks are all now under active discussion. We must respond to the challenges provided by the current situation. It will not only be important to ensure the quality of our work, but we must also consider how we can better carry it forward. I have been discussing with members and with the Secretariat ways in which we could give our work greater exposure. I know how strongly some of you feel about the deficiency of the Committee in this respect. I am hoping that we could now make further progress on this important matter.

The situation that must be faced squarely in our substantive work is that, despite all the painful sacrifices of recent years - the curtailment of living standards already shamefully meagre, austerity piled on insufficiency - the position of many heavily indebted countries remains precarious. As our draft report poignantly reveals, the debt bomb of the newspaper headlines has turned out to be more like a debt cancer - less explosive, but every bit as traumatic and eventually destructive. Tolerance of a deflationary adjustment, more feared for the solvency of the banking system than the welfare of people outside its ken, is wearing thin. For the first time since the end of the Second World War, international capital has begun to flow in a reverse direction - from poor to rich countries, from capital-deficient to capital-generating countries. Whereas policies are unquestionably improving in many third world countries, capital flows continue to decline and on current policies they will remain negative for at least another decade. The slow growth of the world economy also continues to constrain the export prospects of developing countries. As a result of these developments, economic performance has continued to deteriorate whatever efforts Governments make to put their house in order. Hopelessness threatens much of Africa. Without relief of their present financial burdens, rehabilitation remains a distant dream for many countries and hopes of real development an illusion.

Even outside the developing countries, the premature euphoria of 1984 about the debt crisis has all but gone. There is greater recognition that there is a long haul ahead which would require planned and concerted action. It is not simply a question of the old strategy being wrong or deficient. Less excusably, the international community has failed so far to provide the essential ingredients for

the success of the very strategy it preferred to adopt. To rely on the export earnings of developing countries to pay back debts without opening markets for their exports or providing for the investment required to produce those exports and to depend on lower interest rates to reduce debt-servicing burdens without implementing policies in key industrial countries which could bring those rates down are obvious instances where supportive action was required - but not taken - to help the chosen strategy to succeed. The same is true in other areas. The case-by-case approach is made sacred doctrine; but again, as our work for this meeting demonstrates, in practice it means applying the same formula to all cases. Wherever in the developing world a financial crisis emerges, there is one solution - further sacrifices, lower consumption, lower investment and lower growth. The constraining nature of the environment is paid little heed. And, in the absence of wider action, developing countries have had to bear a disproportionate burden in dealing with the debt crisis and, inevitably, many remain in dire straits.

Macro-economic problems facing the world economy, although not directly concerned with our theme, have an important bearing on capital flows to developing countries. High international interest rates are now a problem for all countries. They have a substantial bearing on the burden of debt-servicing and the attractiveness of investment. But indebtedness itself produces wide international repercussions through its impact on international financial stability, its compression of the imports of the affected countries and its aggravation of protectionism through the need to generate huge trade surpluses to repay debts.

These crucial wider interrelationships would require some consideration on our part of the requirements for a more vigorous and substantial recovery in the world economy. It is extremely important that low inflation in the major countries, increasing surpluses in Japan and some Western European countries and low energy prices are seen not just as progress to be consolidated, but as opportunities for concerted and purposeful action - action to invigorate the world economy to rates of growth that would begin to solve the endemic problems of unemployment and poverty.

In our deliberations we must be prepared to confront difficult issues. Too often, in recent times, political considerations have led to sights being set low and development measures, such as capital transfers, being contemplated at levels which respond less to needs than to political feasibility.

Thus, if increases in official development assistance (ODA) are crucial and debt relief for some countries an imperative, we must be able to say so, even though such recommendations are less politically acceptable than others which, as in the case of high levels of capital increase for the World Bank or much new money from commercial banks, might be just as difficult to achieve in practice.

We must endeavour to state boldly the consequences for development if current trends in capital flows are maintained and to point clearly to rational requirements, even though the strategy of getting there would have to take into account political realities.

There are important lessons to be learned from recent experience and at least some of them are now being learned such as the need for greater international discipline on the part of major economic Powers and for larger amounts of external finance to facilitate growth-oriented adjustment in developing countries. Recent initiatives by the United States Treasury Secretary, Mr. Baker, are significant and

welcome steps in this direction. They are necessary measures, but they are not sufficient. The need for more active world economic leadership remains. The incremental capital from the Baker initiative will be barely enough to cover the needs of a few countries and, of course, even if the needs of the 15 Baker countries were met, that would still leave a wide range of developing countries facing serious adjustment problems.

An important element of the required measures concerns the central role which the World Bank should play in increasing resource flows, both directly and as a catalyst, and in shifting the emphasis in adjustment policies to longer-term approaches. The budgetary constraints facing aid flows and the serious confidence problems which will undermine private flows for the foreseeable future indicate a crucial enhanced role for the World Bank and the regional development banks for the period ahead. In this connection, current discussions on the future lending programme for the World Bank and capital resources to support expanded lending assume special significance. To borrow a phrase from a friendly but critical observer, let the giant be hobbled no more.

The International Development Association is, of course, the premier multilateral aid agency. It is also crucial to the needs of low-income countries. The overriding preoccupation of the financial system with the problems of the heavily indebted countries should not obscure the basic problems of survival faced by millions of people in poorer countries, especially in sub-Saharan Africa. Poverty must remain a major focus of the Bank's activities. Yet we have seen a considerable decline in the amounts available under the Seventh Replenishment. Under the Eighth Replenishment, we should be moving back to a long-term path of an expanding IDA. Although negotiations have not yet reached an advanced stage, targets are already being influenced more by political realities than urgent human needs.

Substantial increases in both bilateral and multilateral flows are crucial to enabling many of the poorer developing countries to break out of the desperate financial straits in which they have become trapped. Current trends indicate that flows to sub-Saharan Africa would not be adequate to support even the minimum import needs necessary to revive the many flagging economies in that troubled region. More open debates are needed on these issues. How, for instance, would a public that has responded so generously to African emergency relief react if it were made aware that accompanying its help has been a decline of net official flows for long-term development?

A major aspect of the crisis facing capital flows to developing countries is the sudden collapse of voluntary bank lending. Efforts would have to continue to ensure significant bank lending, even if on an involuntary basis in the short-run. Modest targets for such flows would have to be made for the long-run in order to ensure a more sustainable balance with other flows than in the recent past. Private foreign investment could play a larger role in the structure of capital flows but recent expectations in this regard have been exaggerated, taking into account current poor prospects for profit and the continuing need for an improved, stable and equitable régime for such flows.

Much has to be done in many directions to respond to the vital development issues we have agreed to address. More deliberate and more concerted action is required to clear away the debris of the past which obstructs the pathway to the future. Only when a package of mutually supporting measures is implemented to improve the external environment, increase financial flows and, in some cases, even

provide debt relief, can progress begin towards faster development, greater political stability and more dynamic growth throughout the world. The progress made in co-ordinated action by the major countries in recent months must be extended by a manageable process of negotiations, which must include the developing countries. In our last two reports, we pointed to a possible direction in this regard.

Our work on the main theme of the session will be greatly assisted by the technical preparations which have gone on since our previous session. A Working Group on the subject under my chairmanship met last December, and further work on a draft has been undertaken under the responsibility of Mr. Arsenis, whom we asked to serve as Rapporteur.

Another important task we have before us is the consideration of three applications for Least Developed Country status. The case of two of these applicants, Kiribati and Tuvalu, which are very small economies, was deferred from our last session because the Committee sought clearer guidance. This matter was considered at the second regular session of the Economic and Social Council last July and we have been asked to be flexible in the application of existing criteria. This provides the means (without changing established criteria) for us to make progress in an area in which the Committee's capacity is larger than mere exhortation. I hope we can now respond positively to the obvious needs of these clearly disadvantaged countries.

This Committee has a proud record of speaking out on development issues with integrity and courage. Jan Tinbergen and other predecessors saw to that. In the climate of anti-internationalism that now threatens so many regions of global endeavour, these traditions of the Committee as a body of independent persons are as vital now as they ever were. I am sure we do not lack the will to sustain them in our time.

Annex III

AGENDA

1. Adoption of the agenda and organization of work.
2. World economic situation and prospects, including the impacts of falling oil prices and lower interest rates.
3. "Finance for development: towards a co-operative solution": provisional draft of the report of the Committee:
 - (a) Capital requirements for growth and development;
 - (b) Special needs of sub-Saharan Africa.
4. Identification of the least developed among developing countries: cases of Mauritania, Kiribati and Tuvalu.
5. Adoption of the report of the Committee.
6. Work Programme for 1986-1987.

Annex IV

LIST OF DOCUMENTS

A. Documents of the Committee

1. "The world economy 1985-1987", Note by the Secretariat, (CDP/22/2, February 1986).
2. "Finance for development: towards a co-operative solution", preliminary draft of the Committee's Report (CDP/22/3, 3 March 1986).
3. "Capital requirements for developing countries", Fishlow, Albert, Journal of Development Planning, No. 17 (forthcoming).
4. "Identification of the least developed among the developing countries: The Cases of Kiribati, Mauritania and Tuvalu", Note by the Secretariat and Annexes (CDP/22/4).

B. Background materials

1. International Monetary Fund, "World economic outlook, April 1986" (advance copy).
2. Marris, Stephen, Deficits and the Dollar: The World Economy at Risk, Institute for International Economics, Policy Analysis Series, No. 14, December 1985), Summary.
3. "The Baker initiative: the perspective of the banks", World Financial Markets (February 1986).
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5. McNamara, Robert, Sir John Crawford Memorial Lecture, Washington, D.C., "The challenges for sub-Saharan Africa" (1 November 1985).
6. "Working Paper on the critical economic situation in Africa", Note by the Secretariat (February 1986).
7. World Bank, Financing Adjustment with Growth in Sub-Saharan Africa, 1986-90 (1986).
8. Agarwala, R., "Resource requirements for restoring growth in sub-Saharan Africa" (18 February 1986).
9. Williamson, John, "Prospects for the flow of IMF finance to sub-Saharan Africa" (February 1986).
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11. Pennant-Rea, Rupert, The African Burden, A Twentieth Century Fund Paper, (January 1986).

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