Economic Stabilization in Developing Countries

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Foreword

IN SEVERAL Latin American countries in the 1950s and 1960s, persistent inflation and balance-of-payments difficulties called forth a variety of policies for economic stabilization. More recently, in the 1970s, major international economic disruptions renewed the quest for economic stability as global inflation and the oil price shocks spread inflation and balance-of-payments deficits to virtually all developing regions. At the same time, many developing nations embarked on domestic programs that in themselves added further instability.

By the turn of the decade economic stabilization policies in developing countries had become a highly charged political issue. Were orthodox stabilization policies harmful to national economies, especially to the poorer segments of society? Had the international community failed to provide adequate financing to facilitate adjustment to problems that were international in origin? Was the International Monetary Fund, the main international agency responsible for external financing for stabilization programs, too narrowly focused in its program requirements? Had private banks extended excessive international credit, facilitating lax policies in some countries and necessitating a "bail-out" by public lending?

Fundamental questions have also been raised concerning the theory of economic stabilization. Do the traditional remedies of fiscal and monetary restraint and devaluation take account of the special circumstances of developing countries? Can these or other measures be carried out in ways that avoid prolonged loss of output, and undue concentration of hardship on the poor? Are gradualist programs more effective than shock treatment? How are the purely technical answers changed by considering the limits of tolerance of the political system?

In 1979 the Office of External Research of the U.S. Department of State commissioned the Brookings Institution to organize a conference of experts to analyze the foregoing questions and policy issues. The papers and proceedings of that conference, held on October 25–26, 1979, constitute the text of this volume, which was edited by the conference coordinators, William R. Cline, a senior fellow in the Brookings Foreign Policy Studies program, and Sidney Weintraub, also a Brookings senior fellow at the time of the conference and currently professor of international affairs at the Lyndon B. Johnson School of Public Affairs of the University of Texas. The editors have provided an introduction and summary of the volume. A list of the other contributors with their affiliations at the time of the conference follows the text.

In addition to the individual acknowledgments in the various chapters, the editors acknowledge their indebtedness to many experts in the U.S. Departments of State and Treasury and in the International Monetary Fund for comments, and to Julia Sternberg for typing and logistical administration of the conference. The index was prepared by Patricia Foreman.

The views expressed in this volume are those of its editors and contributors and should not be ascribed to the institutions or individuals whose assistance is acknowledged here and in the various chapters, or to the trustees, officers, or other staff members of the Brookings Institution.

BRUCE K. MAC LAURY
President

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CHAPTER ONE

Introduction and Overview

WILLIAM R. CLINE *and* SIDNEY WEINTRAUB

ECONOMIC stabilization in developing countries concerns attempts to correct excessive or unsustainable balance-of-payments deficits, reduce the rate of domestic inflation, or (usually) both. Frequently, stabilization efforts also involve exchange rate reform and changes in the systems of import protection and export incentives. A country may make these efforts on its own, in conjunction with a supporting financial program from the International Monetary Fund (for example, a standby loan with policy performance conditions), or with financial support from other international or bilateral financial sources.

The Economic Setting

In the 1970s, economic stabilization became a central policy issue for many developing countries and for international agencies. In Latin America, heated controversy over appropriate stabilization policy dates back to the 1950s. In the 1970s, stabilization also became a priority issue for countries in Asia, Africa, and the Middle East, as worldwide inflation and the balance-of-payments pressures associated with higher oil prices affected developing (and developed) countries in all regions.

Table 1-1 shows the sharp acceleration of inflation in developing countries in the 1970s compared with historical levels. The major surge in inflation occurred in 1973 and 1974, when the worldwide economic boom and commodity price increases, and then higher oil prices, led to domestic inflation on a global scale.[1] As table 1-1 shows, inflation rose in all continents, not just in Latin America where an inflationary tradition already

1. For an analysis of the impact of worldwide inflation, see William R. Cline and Associates, *World Inflation and the Developing Countries* (Brookings Institution, forthcoming).

Table 1-1. *Consumer Price Inflation*

Average annual percentage

Country	*1967–72*	*1973–74*	*1975–78*
Africa	4.8	14.0	19.8
Asia	5.4	21.4	7.0
Latin America	15.9	35.8	52.9 (27.7[a])
Middle East	4.3	17.2	20.4 (12.0[b])

Source: International Monetary Fund, *Annual Report 1979*, p. 11.
a. Excluding Argentina, Chile, and Uruguay.
b. Excluding Israel.

existed. Table 1-1 also shows that only national governments in Asia succeeded in bringing inflation down to moderate levels by the late 1970s; elsewhere, developing countries generally had little success in regaining price stability. Moreover, growth in GDP in both middle- and low-income countries in Asia was higher (relative to historical rates) than in other regions over this period, suggesting that successful control of inflation does not necessarily imply a sacrifice of growth in the medium term.[2]

Balance-of-payments problems also plagued developing countries in the 1970s. Following unusual strength in current account balances in 1972 and 1973, the non-oil-exporting developing countries suffered an unprecedented deterioration in external accounts in 1974 and 1975, primarily as the result of higher oil prices and (in many cases) higher real import volumes and sluggish demand for their exports due to economic slowdown in the industrial countries. The aggregate current account deficit of non-oil-exporting developing countries rose from $11 billion in 1973 to an average of $34 billion in 1974 and 1975, representing a rise from approximately 16 percent to 35 percent of export earnings. In contrast to their general inability to recover price stability, in the realm of external accounts developing countries managed to adjust substantially (with the help of recovering terms of trade), and by 1976 and 1977 they had reduced their aggregate current account deficit to $23.5 billion, or approximately 19 percent of export earnings.[3] Even for the relatively benign period of 1976–78, however, the aggregates mask individual cases of particular difficulty. Countries such as Peru, Sudan, Turkey, Zaire, and Zambia experienced "significant problems of debt management" even

2. For growth data, see World Bank, *World Development Report, 1979* (World Bank, 1979), p. 11.

3. International Monetary Fund, *Annual Report, 1979,* p. 23, and *International Financial Statistics,* selected issues.

though developing countries as a whole experienced satisfactory external account performance after 1975.[4]

Beginning in 1979, the international economic setting turned much worse for the non-oil-exporting developing countries. The prices of oil charged by OPEC members rose by approximately 135 percent from the end of 1978 to mid-1980. Primarily because of higher oil prices, the combined current account deficit of the non-oil-exporting developing countries rose from $36 billion in 1978 to $55 billion in 1979, an expected $68 billion in 1980, and was forecast to rise to $78 billion by 1981.[5]

Slow growth in industrial countries, led by the U.S. recession in 1980, limits the prospects for adjustment through rapid expansion of exports by developing countries. To make matters worse, the strength of the fabric of the international monetary mechanism for recycling funds from OPEC countries in surplus to developing countries in deficit stands open to question. Already carrying heavy exposures in developing countries as the result of massive lending following the 1974 oil price increase, the major international banks seem unlikely to be able to repeat their earlier lead role in financial recycling in this second round of oil price increases. Many major American banks are reaching legal ceilings on the ratio of their lending in individual developing countries to their capital. At the end of 1977, U.S. bank loans to non-oil-exporting developing countries already stood at 130 percent of bank capital, and the nine largest American banks had loans to Brazil and Mexico alone amounting to 48 and 38 percent of their capital, respectively.[6] While some scope exists for European, Japanese, and U.S. regional banks to replace the largest U.S. banks in expanding new loans to developing countries, the prospects are that the private banking sector's ready solution to the financial recycling problem of the mid-1970s will no longer be available in the early 1980s. Instead, greater reliance on official lending is likely, as well as a greater role for direct lending from OPEC countries to non-oil-exporting developing countries.

Despite their inflationary and balance-of-payments problems, the developing countries managed to sustain economic growth relatively well

4. *World Development Report, 1979,* p. 29.

5. International Monetary Fund, *World Economic Outlook* (May 1980), pp. 5, 95.

6. Jane D'Arista, "Private Overseas Lending: Too Far, Too Fast?" in Jonathan D. Aronson, ed., *Debt and the Less Developed Countries* (Westview Press, 1979), p. 67.

during the 1970s. Comparing 1970–77 with 1960–70, annual average GDP growth rates fell moderately, from 3.9 percent to 3.2 percent for low-income countries and from 6.2 percent to 6.1 percent for middle-income countries. By contrast, industrial country growth fell from 5.1 percent to 3.1 percent.[7] Whether this relatively strong performance of developing countries will continue into the 1980s remains to be seen. One factor that will influence the outcome is whether the international mechanisms for financial recycling, both private and public, prove to be fragile or robust. One of the most important of those mechanisms is the conditional lending by the International Monetary Fund in support of economic stabilization programs.

The Policy Setting

The question of how to deal with inflation and balance-of-payments difficulties raises policy issues at both international and national levels. The International Monetary Fund (IMF) is the international agency charged with helping member nations carry out stabilization programs. Many spokesmen from developing nations have criticized the IMF's performance of this role, however. They maintain that its criteria of loan "conditionality" have been too rigid.[8] One influential analysis maintained that external factors, especially deteriorating terms of trade and recession in industrial country markets, had been primarily responsible for stabilization problems in developing countries in the 1970s, and that stabilization programs under international auspices should accordingly increase the amount and flexibility of balance-of-payments support.[9] Journalistic accounts often painted the IMF as the heavy-handed villain in stabilization efforts that resulted in rioting in Egypt and Peru.

The IMF has sought to review its approach to stabilization programs. One staff analysis of past conditional lending (standby programs) concluded that the purposes of the programs had been achieved in 72 percent of the cases, that there was no evidence that the programs decreased

7. *World Development Report, 1979,* pp. 128–29.

8. Thus, at the 1978 annual IMF-World Bank meetings, the developing country Group of 24 stated concern about "the multiplicity of performance criteria and some other forms of conditionality that inhibit access to Fund resources." *IMF Survey,* October 2, 1978, p. 307.

9. Sidney Dell and Roger Lawrence, *The Balance of Payments Adjustment Process in Developing Countries* (London: Pergamon Press, 1980).