

CHANGE AND CHALLENGE IN THE WORLD ECONOMY

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MACMILLAN

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Preface

The decade following the 1971–3 worldwide boom saw important changes in the world economy. Oil prices quadrupled in the years 1973–4 and increased two-and-a-half times in 1979–80. The anti-inflationary policies adopted by the developed countries deepened the ensuing recessions and, after 1980, increases in real interest rates further aggravated the world economic situation.

The changes that occurred constituted challenges to economic policy-makers in the individual countries. The essays of this volume examine the different ways in which policy-makers responded to these challenges. They also consider possible future policy changes that may be desirable to meet the challenges which lie ahead in the future.

Following a review of incentive policies and their economic effects in developed, developing, and socialist countries in Part I of the volume, the essays of Part II examine policy responses to external shocks in the developing countries and the implications of these policies for their external debt. In turn, the essays of Parts III to V, respectively, analyze the policies applied by several developing countries, Mexico, Chile, Portugal, Turkey, and Korea; review the reform efforts made in two socialist countries, Hungary and China; and evaluate recent policy changes in a developed country, France. Finally, the essays of Part VI of the volume investigate recent developments in trade in manufactured goods between the industrial and the developing countries and make recommendations for future changes in their trade policies, with a view to promoting structural transformation and economic growth.

The country essays of Parts III to V have been prepared as policy advisory reports for the governments concerned or written for international conferences and seminars. These essays, as well as the general essays of Parts I, II, and VI, have been published in professional journals or collective volumes. Permission for publication to all concerned is acknowledged in the Reader's Guide to the volume. Essays 1, 2, 4 to 14, 18, and 19 have been prepared in the framework of a consultant arrangement with the World Bank.

I am indebted to Kenneth Meyers, Eric Manes, and Shigeru Akiyama for research assistance beyond the call of duty. Special thanks are due to Norma Campbell, who patiently bore the burden of typing the text and tables, with innumerable revisions. Keith Povey has done an excellent job as editor.

I wish to express my appreciation to government officials, economists, and businessmen in the individual countries for useful discussions. However, I am alone responsible for the opinions expressed in the essays that should not be interpreted to reflect the views of particular governments or those of the World Bank.

Washington, D.C.

BELA BALASSA

A Reader's Guide

The volume begins with a review of incentive policies and their economic implications in developed, developing, and socialist countries. The introductory essay examines the effects of government directives and interventions that create distortions in the system of incentives.¹ The broad conclusion is that reductions in policy-imposed distortions in product, labor, and capital markets would permit reaching higher levels of efficiency and raising the rate of economic growth in the countries concerned.

Essay 2 examines in greater detail policy-imposed distortions in developing economies, and it reports available estimates of the impact of these distortions on the allocation of existing resources, savings, investment efficiency, and economic growth.² The findings show the high economic cost of policy-imposed distortions in product and factor markets in terms of foregone incomes and point to the gains that may be obtained by removing or alleviating these distortions.

In turn, Essay 3 analyzes the economic consequences of the social policies applied by the industrial countries.³ It is shown that, in reducing the demand for, and the supply of, labor, social policies have adversely affected employment and economic growth in Western Europe. These distortions are of lesser importance in the United States, which fact has contributed to the superior performance of the American economy in recent years. In the essay, recommendations are made for reforming social policies in European countries, with a view to promoting structural change and reducing the burden of social legislation on the working population.

The three essays of Part I on incentive policies and their economic effects are followed by the essays of Part II that examine the policies applied by developing countries following increases in oil prices in 1973–4 and 1979–80 and the world recessions of 1974–5 and 1980–2. Essays 4 and 5 evaluate policy responses to these external shocks by developing countries pursuing outward-oriented and inward-oriented policies while Essay 6 considers the implications of policy differences for the debt problem in developing countries.

Following a brief discussion of the policy experience of twenty-eight developing countries in the 1973–8 period, Essay 4 considers the principal elements of a policy package that may be applied in developing countries to respond to external shocks while undertaking policy reforms.⁴ Such a package would include improvements in production incentives, in incentives to save and to invest, in the allocation of public investment, in sectoral policies, as well as in budgetary and monetary policies.

Essay 5 examines the policies applied in developing countries in response to the external shocks of the 1974–6 and 1979–81 periods.⁵ It is shown that while outward-oriented economies pursued output-increasing policies of export promotion and import substitution, inward-oriented economies relied largely on foreign borrowing to finance the adverse balance-of-payments effects of external shocks.

The policies applied led to economic growth rates substantially higher in outward-oriented than in inward-oriented economies. Also, the foreign indebtedness of the latter group of countries increased to a considerable extent, leading to repayment problems. In turn, exports rose *pari passu* with foreign borrowing in the former group of countries that maintained their creditworthiness. These consequences of alternative policies are considered in Essay 6 of the volume that also makes policy recommendations aimed at improving the debt situation in inward-oriented economies.⁶

The comparative studies of Part II are followed by essays devoted to individual countries in Part III of the volume. These essays analyze the policies applied, and the economic consequences of these policies, in Mexico, Chile, Portugal, Turkey, and Korea during recent periods of external shocks. The essays deal with incentives and macroeconomic policies and make recommendations for future policy changes.

Essay 7 on Mexico indicates the similarities observed in the policy cycles of the 1972–6 and 1977–81 periods.⁷ It is shown that, under fixed exchange rates, expansionary fiscal policies repeatedly led to the overvaluation of the peso, triggering the application of protectionist measures. The overvaluation of the currency was supported by borrowing abroad but, in the absence of the efficient use of borrowed funds, the accumulation of external debt eventually gave rise to a foreign exchange crisis. The essay makes recommendations for remedying macroeconomic disequilibria, reducing price distortions, and liberalizing trade in Mexico, so that the deflationary effects of the stabilization policies applied after December 1982 can give place to rapid economic growth under increased outward-orientation.

In Chile, an outward-oriented development strategy was adopted after the military takeover in September 1973, involving the establishment of realistic exchange rates, the elimination of import licensing, reductions in import tariffs to 10 percent, the freeing of interest rates, and the liberalization of prices.⁸ However, in June 1969, the exchange rate was fixed in terms of the US dollar, leading to the increasing overvaluation of the currency as official wage adjustments continued and wages doubled over a period of less than three years. At the same time, with a virtual exchange rate guarantee, Chile experienced an excessive capital inflow, eventually giving rise to a financial crisis. The reversal of policies applied, entailing increased price distortions, then, undermined the beneficial effects of the reform measures of 1973–8.

Following a successful stabilization program in 1978–9, growing government deficits and the poor performance of public enterprises contributed to a rising balance-of-payments deficit in Portugal. Improvements occurred following the measures applied in June 1983, but they entailed a substantial cutback in private investment. Yet, new investments are necessary to improve the competitiveness of the Portuguese economy on entering the European Common Market. Essay 9 makes recommendations for policies that may be applied in the pursuit of this objective, involving reductions in the financial requirements of the public sector, improvements in the operation of public enterprises, and the provision of appropriate incentives to the private sector.⁹

Turkey had long pursued a policy of inward orientation, accompanied by considerable government intervention. The January 1980 measures, including a substantial devaluation, export incentives, import liberalization, and the freeing of prices and interest rates, represented important steps towards outward orientation and increased reliance on market forces. These measures led to rapid export growth that, in turn, permitted increasing output and improving the balance of payments. However, private investment remained low and difficulties were experienced in the financial sector. Essay 10 makes recommendations to remedy these shortcomings and to attain the objective of stable economic growth in Turkey by further increasing the outward orientation of the economy and the scope of operation of market forces.¹⁰ Steps in these directions have been taken after the installation of the new Ozal Government in December 1983; the postscript to the essay reviews these developments and makes recommendations for further changes.

Korea has been considered as one of the success stories among

developing countries. Following the application of an outward-oriented development strategy, it achieved high rates of economic growth and successfully surmounted the external shocks of the 1973–5 period. Essay 11 describes the unfavorable economic effects of the policy reversal that occurred in 1978–9 and evaluates the measures taken to remedy these adverse consequences in 1980. It also makes recommendations for policies to re-establish and further advance Korea's outward-oriented development strategy.¹¹ The postscript to the essay describes the measures that have since been taken in the pursuit of this objective.

The essays of Part IV evaluate the policy reforms applied in two socialist countries, Hungary and China, and make recommendations for further reform measures. Essay 12 reviews the new economic mechanism introduced in Hungary in January 1968. This reform represented an important departure for a socialist economy in replacing centralized planning by decentralized decision-making and involving the use of prices linked to world market price relations in the allocation process.¹² The essay examines the favorable impact of the original reform measures, the adverse economic consequences of the partial recentralization of decision-making after 1972, and the introduction of new measures in 1980–1 that carried forward the original reform effort.

In turn, Essay 13 examines the measures applied in 1980–1 in greater detail and makes recommendations for further changes to pursue the objectives of the reform.¹³ The recommendations concern strengthening the link of domestic to world market prices, adopting a realistic exchange rate, giving a greater role to firms in decisions on investment, and decentralizing economic decision-making in general.

As in Hungary, economic reform in China would have to involve the decentralization of decision-making, the use of prices as signals for resource allocation, appropriate incentives on the firm level, and competition among producing units. At the same time, in view of differences in the size of their national economies, there is scope for domestic competition in China while Hungary needs to rely to a considerable extent on import competition. Correspondingly, apart from standardized products that enter international trade, a system of price determination in the framework of domestic markets would be appropriate in China whereas links to world market prices need to be strengthened in Hungary. Essay 14 reports on progress made in reforming Chinese agriculture and suggests further reform measures for the future.¹⁴ The reforms announced in October 1984 represent

important steps in the reform effort.

Among developed countries, France provides a particularly interesting case of successive policy reversals. The policy of stability under Raymond Barre was followed by efforts aimed at economic expansion via social measures under the socialist government, subsequently leading to policy changes as the balance of payments deteriorated and inflation accelerated. The essays of Part V examine the policies applied and their economic effects, with further attention given to possible future changes.

Essay 15 evaluates the policies followed by the government of Raymond Barre, aiming at economic growth with stability while increasingly liberalizing the economy.¹⁵ It is noted that, following improvements in economic performance, adverse developments in the world economy contributed to increased unemployment in France. In the essay, recommendations were made for remedying the situation by increasing the rate of investment.

In the event, high unemployment contributed to the socialist economic victory in the Spring of 1981. Essay 16 examines the economic policies adopted by the new socialist government. Following a discussion of the structural policies of nationalization, decentralization, and planning, attention is given to the expansionary measures applied that led to wage inflation and the deterioration of the balance of payments.¹⁶ While policy was reversed after March 1983, in Essay 17 it is shown that adverse consequences in the form of low profit margins and high external indebtedness remain.¹⁷ The essay makes recommendations for measures that may be taken to improve the situation, including reductions in the budget deficit, the rationalization of public enterprises, price liberalization, decreases in the share of wages and salaries, and reductions in social charges for enterprises.

Finally, the essays of Part VI investigate the changing division of labor in manufactured goods between the industrial and the developing countries and provide an appraisal of the measures of protection applied by the industrial countries in recent years. Proposals are further made for trade liberalization by the industrial countries and the NICs, with a view to promoting structural transformation and economic growth.

Essay 18 examines recent trends in manufactured trade between the industrial and the developing countries that assumed increased importance as markets for each other's manufactured products.¹⁸ This has occurred, notwithstanding the imposition of protectionist measures in some areas by the industrial countries. These measures are described in

Essays in this volume argue the need for a new round of multilateral trade negotiations to reverse recent protectionist tendencies and to avoid further destabilizing.¹⁹ It is further noted that involving the developing countries in the negotiations would not only allow the more industrialized countries to adopt rational trade policies but would strengthen the argument for trade liberalization in the developed countries.

Essay 20 further develops the arguments for a new round of multilateral trade negotiations.²⁰ The essay examines the interests of industrial and developing countries in the mutual liberalization of their trade. It also considers the steps that may be taken to prepare the negotiations, the modalities of the negotiations themselves, and the need for taking adjustment measures to accompany the trade liberalization effort in both the industrial and the developing countries.

NOTES

1. The essay was prepared as an invited paper for the conference on Economic Incentives, organized by the International Economic Association and held in Kiel, Germany, in June 1984. It appeared in *Weltwirtschaftliches Archiv CXX* (1984) and will be included in the Conference proceedings to be published by Macmillan, London.
2. Essay 2 was presented as an invited paper at the December 1981 meetings of the American Economic Association held in Washington, DC; it first appeared in *World Development*, a publication of Pergamon Press Ltd, Oxford X (December 1982) pp. 1027-38.
3. Essay 3 was presented at the Institute of World Economics, University of Kiel, upon receiving the Bernhard Harms Prize on 23 June, 1984. It appeared as No. 11 in the Bernhard-Harms-Vorlesungen series (1984) and in *Weltwirtschaftliches Archiv CXX* (1984) pp. 213-27. It will be published in French translation in *Commentaire*.
4. This essay, prepared for the World Bank, originally appeared in *World Development X* (January 1982) pp. 23-38.
5. Essay 5 was presented as an invited paper at the December 1983 meetings of the American Economic Association held in San Francisco. It was published in *World Development XII* (December 1984) pp. 1027-38.
6. This essay was presented at the Conference on The International Monetary System and Economic Recovery, organized by the Istituto Bancario San Paolo di Torino and held in Turin, Italy in March 1984 and, in a revised form, at the 40th Congress of the International Institute of Public Finance, held in Innsbruck, Austria in August 1984. It will be published in the Proceedings of the Conference by the Istituto Bancario San Paolo di Torino and in the Proceedings of the Congress by the Wayne State University Press.
7. Essay 7 was prepared for the Conference on Industrialización y Comercio Exterior, organized by the Colegio Nacional de Economistas and held in

- Mexico City in January 1983. It was published in *World Development* XI (September 1983) pp. 795–812 and, in Spanish translation, in *Comercio Exterior* XXX (March 1983) pp. 210–22.
8. The essay was prepared as an advisory report for the Government of Chile. It was published in Gary M. Walton (ed.), *The National Economic Policies of Chile* (Greenwich, Conn.: JAI Press, 1985). Spanish translation in *Estudios Públicos* No. 14 (Otoño, 1984) pp. 49–90.
 9. Essay 9 was prepared as an advisory report for the Government of Portugal. It was published in *Economia* (October 1984).
 10. This essay was presented as an invited paper at the Third Conference in the Role of Exchange Rate Policy in Achieving the Outward Orientation of the Economy, organized by Meban Securities and held in Istanbul in August 1982. It appeared in *The Middle East Journal* (Summer 1983) pp. 429–47. The postscript to the essay was excerpted from a presentation made by the author at the Council on Foreign Relations in June 1984.
 11. Essay 10 was prepared as an advisory report for the Government of Korea and published in 1981 as No. 10 in the *Consultant Paper Series* of the Korea Development Institute.
 12. This essay was presented as an invited paper at the US–China Conference on Alternative Development Strategies, organized by the Committee on Scholarly Communication with the People's Republic of China and held in Racine, Wisconsin in November 1980. It first appeared in the *Banca Nazionale del Lavoro, Quarterly Review* No. 145 (June 1983) pp. 163–84.
 13. The essay was presented as an invited paper at a joint session of the American Economic Association and the Association for Comparative Economic Studies, held in Washington, DC, in December 1981 and at the Conference on Hungarian Economy and East–West Relations held at Indiana University, Bloomington, Ind., in March 1982. It was published in the *Journal of Comparative Economics* VII (September 1983) pp. 253–76.
 14. Essay 14 was presented as an invited lecture at the Economic Institute of the Chinese Academy of Social Sciences in May 1982. It appeared in *Banca Nazionale del Lavoro Quarterly Review* No. 142 (September 1982) pp. 307–33.
 15. This essay was prepared as an invited paper for the Conference on The Political Economy of France: Current Developments and Prospects, organized by the American Enterprise Institute for Public Policy and held in Washington, DC, in May 1980, and appeared as Johns Hopkins Working Paper in Economics, No. 62. It was published in French translation in *Commentaire* III (Autumn 1980) pp. 437–51.
 16. This essay was presented as an invited paper at a seminar held at the American Enterprise Institute for Public Policy in Washington, DC, in September 1982. It was published in the Institute's series *Studies in Economic Policy* (1982), in *Tocqueville Review* IV (Fall–Winter 1982) pp. 337–58, in *Quadrant* (July 1983) pp. 54–62 and, in French translation, in *Commentaire* V (Autumn 1982) pp. 415–28.
 17. Essay 17 was presented as an invited paper at a seminar held at the American Enterprise Institute for Public Policy in Washington, DC, in March 1984 and appeared in the Institute's series *AEI Occasional Papers, Studies in Economic Policy* (April 1984). It was published in *Tocqueville*

Review VI (Spring–Summer 1984) pp. 183–98 and, in the French original, in *Commentaire VII* (Printemps 1984) pp. 13–22.

18. This essay was presented as an invited paper at the Seventh World Congress of the International Economic Association, held in Madrid 1983. It appeared as World Bank Staff Working Paper No. 611 and will be published in the Proceedings of the Congress. Spanish translation in *Información Comercial Española* No. 605 (January 1984) pp. 58–68 and in *Industrialización y Desarrollo* (January–June 1984) pp. 85–100.
19. Essay 19, written jointly with Carol Balassa, was published in *The World Economy*, the quarterly journal of the Trade Policy Research Centre, London, VII (June 1984) pp. 179–96.
20. This essay was prepared for the Secretariat of the Organization for Economic Co-operation and Development and published in *OECD Economic Studies* No. 3 (Fall 1984) pp. 7–25.

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