Growth, debt and development

The ***Governor*** *reviews[1] the problems facing the world economy and in particular the prospects for heavily indebted middle-income developing countries. He argues that for these countries relief of the kind proposed for the poorest African states would be neither practical nor appropriate and that the key to a long-term solution must lie in adjustment. As an exemplar of the way forward he points to the experience of the economies of the Far East and the common factors behind their successful economic performance—adoption of a free enterprise system and freer markets, export-oriented policies, development of agriculture, encouragement of high saving rates and a willingness to adjust monetary and exchange rate policies to changing circumstances.*

Although I speak with an admitted bias, I can think of few more splendid settings than Leeds Castle for the annual joint meeting of your two societies. In this rare and serene place it is all too easy sometimes to forget the world outside. And yet, this is a fortress, built to withstand attack and siege, and with drawbridge and moat which show only too clearly how well the builders understood the dangers and uncertainties that threaten life and prosperity.

The dangers are now different in kind. But as one contemplates the tensions between debtor and creditor countries, and the continuing current account imbalances between the major industrial countries—as one contemplates in particular the Trade Bill now before the US Congress—one is bound to reflect that moats and drawbridges are perhaps not as far removed from our experience as they ought to be.

The world economy

This is admittedly a rather sombre way of putting it, and in assessing the immediate prospect for the world economy it would be wrong to lay too much stress on the obvious risks, or indeed to ignore what has been achieved. After the mistakes and excesses of the 1970s, the industrial countries have done much to put their economies on a sounder footing. They have substantially cut inflation, and they have pulled out of the recession of the early 1980s. In this country, the economic recovery has been stronger and more sustained than in most. Although expansion in the major seven industrial countries slowed marginally last year, the outlook for this year and next is for steady if unspectacular growth of less than 3% annually.

Yet one is aware of a certain tension even in these short-term forecasts, and looking further ahead the uncertainties become still greater and the range of possible outcomes wider. The main reason for this is the size of the payments imbalances between the three major industrial countries; projected into the future on anything like their present scale, these imbalances look unsustainable at present exchange and interest rates. Progress towards correcting them, although not negligible, has thus far been disappointing. The US fiscal deficit remains substantial and, for 1988, uncertain; and the full impact of the adjustment in exchange rates that took place between the Plaza agreement in 1985 and the Louvre agreement earlier this year has yet to be reflected in trade balances. Of course, the most anxious period of any cure is that spent waiting for the medicine to take effect, and the single greatest threat now to continued steady growth remains a sudden loss of confidence pushing the dollar sharply downwards. We have now, in the framework of the Louvre agreement, a means of helping to stabilise the dollar's international value, and the continuation and strengthening of these arrangements is one of the most important items on our Washington agenda.

The developing countries, and the debt strategy

But even if the forecast growth rates are achieved and sustained, and even in the absence of threatened protectionist measures, export markets for the developing countries are growing much more slowly than in the 1970s. Many commodity prices have recovered, but they remain depressed in real terms. At the same time, real interest rates, whose low or negative levels in the 1970s were so fatefully tempting to many borrowers, remain high. This is not an easy environment for developing countries, and it is scarcely surprising that the debt strategy has been showing signs of strain.

In the shadow of Brazil's continuing moratorium, and of the uncertainties surrounding others of the heavily-indebted middle-income countries, it is easy to understand how progress in resolving the debt problem must seem painfully slow, both to debtors and to creditors. For debtors, economic growth and investment is curtailed by the burden of old debt and the reluctance of lenders and investors to provide new external finance. The confidence of creditors, meanwhile, is impaired by the evident unwillingness of some of the major debtors to

(1) In a speech at the annual joint meeting of the British-Malaysian and Malaysian-British Societies at Leeds Castle, on 24 September.

adopt and maintain realistic policies, and by the endlessly repeated exercises in brinkmanship that have accompanied major reschedulings. With their balance sheets now much strengthened, the banks are less ready to provide new money.

There is, I fear, no financial conjuring trick that will make these problems go away. We may be able to provide substantial and much needed relief for the poorest countries, notably those of sub-Saharan Africa, whose debt burdens, although small by some standards, are simply out of line with their economic resources and potential. Here the proposals made earlier this year by the Chancellor of the Exchequer to provide immediate relief on official debts, as well as expansion of the IMF's Structural Adjustment Facility, could enable many of those countries to make a success of their adjustment programmes. But for the middle-income debtors, it is difficult to make any convincing case for relief of this kind, even if it were practical. Many have substantial natural resources and a manufacturing base, and scarcely present a picture of acute need. And it should not be forgotten that many middle-income countries have managed their affairs so prudently as to have avoided any debt problem. To provide relief to the improvident and irresponsible would scarcely be a helpful signal to the world at large.

For the major problem debtors there seems, in fact, little alternative to the case-by-case approach by which the international debt problem has been handled from the outset, and to the framework provided over the past few years by the Baker plan. This links adjustment by debtors, under IMF and IBRD auspices, with action by creditors to restructure existing debts and where appropriate to provide new finance. While the likelihood of new finance has clearly become less, the range or 'menu' of restructuring possibilities is being extended all the time.

Adjustment and growth

But the key to any long-term solution must lie in adjustment, and one of the more depressing features of the debt problem has been the unwillingness of many countries to adopt responsible, internationally-acceptable programmes. One can readily understand why not: adjustment tends to be associated with short-term measures to correct external imbalance; with austerity, higher domestic prices and lower imports. Such programmes have in the past provoked riot and even revolution; and the greater the economic mismanagement of the past, the more painful the cure.

In many cases this painful medicine has to be swallowed; and generally it helps, at least to alleviate the immediate symptoms. But it seldom goes to the root of the problem, and tends to be abandoned with ill-disguised relief as soon as the external indicators become more favourable and a modicum of international confidence returns. I believe that the pain of adjustment could be lightened, and the cure made more permanent and complete, if developing countries were to study the experience and successes of the economies of the Far East. The policies adopted by those countries could appreciably assist the efforts of developing countries elsewhere.

Look East . . .

I well recall the remarkable speech that Dr Mahathir gave at the International Monetary Conference in Hong Kong in 1985. In his very telling analysis of the successes of the Far Eastern countries, he identified five common factors:

- adoption of a free-enterprise system and freer markets;
- commitment to export-oriented policies;
- the development of agricultural capacity and productivity;
- achievement of high savings rates; and
- a readiness to adjust policy to changing circumstances

Now for many countries—and not only developing ones—this represents a radical prescription. But let us consider the benefits.

First, *free enterprise and freer markets.* Few countries can entirely resist the temptation either to control or to try to feather-bed their wealth-creators. But it is clear that the most dynamic and efficient economies are those in which such rigidities are least in evidence. Free-market policies are a magnet to foreign investment, which can make an important contribution to growth, as well as encouraging transfer of technology and management skills. Malaysia's achievement in doubling foreign investment flows in manufacturing in the first half of 1987 is particularly noteworthy.

Most of the governments of the Asia-Pacific region are committed to a free-market economy, or are in the process of dismantling state intervention in favour of private enterprise. Many have also seen the folly of high import barriers, especially those involving quantitative controls—as well as being inflationary, these distort the pattern of local production and damage export potential. Yet in many developing countries elsewhere, the underlying philosophy is inward-looking, based on import substitution: self-sufficiency, even a fortress economy, is often the order of the day. Even those who take a wider view often stifle their entrepreneurs with complex planning and currency restrictions, creating a new breed of inefficiency as well as needless bureaucracy.

Of course, I recognise the difficulty of arguing against protectionism in developing countries at a time when so many developed countries are adopting or threatening protectionist measures of their own—many directed against the economies of the Far East. Non-tariff and discriminatory measures have proliferated in the 1980s; and conflicts have repeatedly arisen over subsidies and dumping. There has been increasing recourse to 'retaliation' to coerce trading partners to reform—and many of these countervailing measures have become permanent. This trend, for long evident in agriculture, steel and textiles, has spread to other sectors such as consumer electronics and cars. But just as protection is a poor response to competition, so I believe it is an equally bad response to protection elsewhere. And I certainly do not believe that developing countries should despair of the world economy and turn inwards. *Export-oriented policies* remain the best prescription.

Protectionists have tended to concentrate on what they perceive as the Asian propensity to 'over-export'. Dumping is, of course, a legitimate cause for concern. However, the success of Asia's exporters has been based, at least in part, on their ability to recognise changing market conditions and to respond to them effectively. Low unit labour costs have enabled them to capture a significant share of the world market in heavy industrial goods such as steel and shipbuilding, and the assembly of a wide range of electronic and other goods. As their skills have developed, countries have now begun to move upmarket into more sophisticated processes, leaving the way open to poorer countries in the region and elsewhere.

As a farmer, I am quick to appreciate the importance of *agriculture* in any economy, and I am particularly impressed by the way in which many countries in the region have harnessed agricultural production to enhance and diversify their export base. Malaysia, for example, has successfully capitalised on its abundant supplies of rubber to build up a variety of manufacturing outlets. Asian countries appear also to have avoided the mistake of developing industry at the expense of agriculture, and they are now reaping the benefit of both. The Indonesian version of 'green revolution' has transformed that country from the world's largest importer of rice into a net exporter. In India and China the transformation has been even more pronounced. It is now more than likely that the impact of the current drought will be confined to manageable levels and the spectre of famine averted—an outcome barely imaginable ten years ago.

High savings ratios have in many cases enabled development to be financed from domestic savings; in Taiwan, Singapore and Hong Kong savings ratios of 30% or more of GNP have been the norm for several years, and this has made possible the development of export-based industries without recourse to significant levels of foreign borrowing. This process has been aided in some countries by liberal financial policies and active capital markets; and it provides a stark contrast with many developing countries where, for a variety of reasons, private savings often take flight in direct proportion to the severity of the controls intended to keep them in.

Admittedly, few developing countries can expect entirely to finance their own development. But we can look East, too, for examples of prudent and responsible debt management. In Korea foreign inflows have been invested in a variety of productive, foreign-exchange-earning industries, which have ensured that Korea's ability to service debts is not put at risk by volatile commodity prices or capricious shifts in demand for a restricted range of export products: and on present trends, Korea could become a net creditor by the end of the century. Other countries—Indonesia, for example—have been ready to adopt firm and often difficult policies in order to maintain their credit standing.

The willingness to *adjust policy to changing circumstances*—the final element in Dr Mahathir's prescription—has undoubtedly played a crucial part in maintaining the momentum of the region. Responsible fiscal and monetary policies have not only contributed to growth but have also acted as a cushion against external shocks. Monetary policies have been geared to resist inflationary pressures, enabling countries to maintain and even sharpen their competitive edge. Malaysia is an obvious example: an annual inflation rate of 12% in 1981 was halved to 6% in 1982 and reduced to less than 1% by 1985. Fiscal policy has also tended to be prudent. Hong Kong has had little recourse to deficit financing; South Korea's fiscal position is currently in balance; and Singapore has run a fiscal surplus almost uninterruptedly since 1968.

An appropriate exchange rate policy is a key element in successful adjustment. Too many countries have regarded an overvalued exchange rate as an outlet for nationalist sentiment rather than a component of trade policy. In East Asia this has not been the case. Governments and markets have generally made adjustments to the exchange rate in response to trade and macroeconomic conditions. This is surely the wisest course—but they need also to guard against persistent overshooting in the opposite direction, and thus creating over a long period exceptionally large balance of payments surpluses and high levels of reserves. The virtues of free and fair competition need to be recognised and fostered by everyone with a major stake in world trade.

The global perspective

The economies of the Far East have not, of course, solved all of the problems confronting them. Above all, they remain exposed to the dangers of increased protectionism. But the lessons to be drawn from the Asian success story should not be lost on other economies, either in the developing or the developed world. At the outset of the Uruguay round, we must all recognise that further trade liberalisation, even turning back the protectionist tide, will require considerable progress in resolving the financial and structural problems which continue to dog both developed and developing countries. And it is here that we, from a more westerly viewpoint, have most to learn by following Dr Mahathir's advice to 'Look East'. What the economies of the region have shown is that where trade and domestic structural issues are addressed together, there need be no trade-off between healthy growth and price stability. But all countries, even the economic dragons and tigers of Asia, might do well to remember that successful economic performance is ultimately based on free trade, competition, and private initiative.