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Korea will, at present rates, pay off its debts within four years) while some debtors hope to expand manufactures exports. But this disparity may be the main point. Relative to the rest of the world, all developed countries are alike; but each group of less-developed countries is underdeveloped in its own way.

Comments on Paul Krugman's Essay

EDMAR L. BACHA: I want to tell another story. Paul said that creditors decided to buy time for the debtors to get out in a fortunate way. I would suggest that there is another way of looking at it. The strategy of financing was a way of buying time for bankers to get out of it. If it had not been done that way in 1982, the whole banking system of the United States might have gone into bankruptcy. So, time had to be bought for that. I think that was the main issue. Once time was bought, banks got some interest payments, more than the money they put in. With that money, they could increase reserves. The hope was that in time there would be reserves enough.

German and Swiss banks—and maybe the Japanese, although we do not know much about them because they do not publish their accounts—apparently took the lesson seriously. But not the money-center banks in New York and California. Why is that? I want to present four possibilities. One is the “trust effect,” a moral hazard, a consequence of official intervention. The other, their belief in Bill Cline’s optimistic projections, which explains their misconception of what was going on. The third relates to taxation. They have no tax rebates in the way that European banks have on general reserves. Finally, banks’ profits were not sufficient; they had been left with too many bad domestic loans. The money-center banks were under the threat of being written off.

We saw what happened last year in the wake of the moratorium by Brazil. The money-center banks moved to increase their reserves. Once the flood-gates were open, there was an attempted second wave to move up reserves. It started last November here—with the Bank of Boston and American Express—but also in Chicago and California, where reserve ratios went up 50 percent and more in order to match the level the market discount showed was needed.

And then all this stopped because of the open intervention of both the Bank of England and the New York Federal Reserve Bank. The reason is

quite clear. Manufacturers Hanover, for example, would have to commit 131 percent of its total equity in order to satisfy this reserve provision. So you still have a problem. There are four major banks here (and two more in England) that need to be restructured, that need to be taken over. That, I think, is the main issue. Bank restructuring in this country is what it is really all about.

Another point: Why did developing countries not behave otherwise? That has always surprised me. In a paper that I wrote with Carlos Diaz just before the debt crisis erupted, we imagined that the scenario of the 1930s would be repeated. Countries just wouldn't pay, and the problem would be transferred to the creditors. We were totally wrong in that.

Still, there are some lessons to be learned when you look at the Brazilian experience last year. The total foreign liabilities of Brazil are roughly 60 percent long-term bank debt, 25 percent official credit, 5 percent trade credit, and 10 percent direct investment. We had a net negative financial transfer with the private banks but not with the rest of the group, except for one year. Then, as far as trade credit, official credit, and private investment are concerned, we are potentially on the plus side. What happened last year, clearly, is that there was a ganging up on Brazil. We saw the interruption of flows from the World Bank, the interruption of trade credit. We had for the first time negative direct investment.

I shift back to the idea that what is basically needed is to have something done with the banking system here. Banks have taken collective action in lending; now they need to take collective action in forgiving. For a bank, individually, is worse off if it forgives; that action does not by itself improve the capacity of the country to pay.

JEFFREY D. SACHS: Paul Krugman's very interesting and provocative paper has two main parts: a discussion of trade policy and trade performance in developing countries, and an analysis of the ongoing developing-country debt crisis. As we have come to expect with Krugman's papers, we are treated to provocative hypotheses that are original, thought provoking, and clearly stated. There is much to learn from Paul's analysis of the trade and debt issues, but I also believe that Paul leads us a bit astray at certain points. Let me explain.

I will begin with the issue of trade policy. Krugman's emphasis is on the emergence of major manufacturing exporters in the developing world, particularly in East Asia. He rightly indicates the fundamental importance of this phenomenon, not only for the changing relations between developed and developing countries but also for our most basic thinking about the processes of economic development.

For the first couple of decades after World War II, the "standard" approach to development stressed the goal of shifting workers from

agriculture to import-competing industry. In the dominant import-substitution model, the industrial sectors would produce for the domestic market, thereby substituting for imports that were formerly paid for by primary commodity exports. This strategy was justified on many grounds, including the famous Prebisch-Singer hypothesis that primary commodities prices would inevitably experience a secular decline in world markets, thereby rendering primary commodities a major drag on the development process.

As Krugman stresses, the remarkable surprise of the past twenty-five years has been the emergence of manufacturing exporters in the developing world, who have boomed on the basis of rapidly growing exports to the industrial world. The emergence of superexporters such as the "Gang of Four" in East Asia (Hong Kong, Singapore, South Korea, and Taiwan) and many of the ASEAN countries (e.g., Indonesia, Malaysia, and Thailand) have led to a shift in development theory, to a new orthodoxy which stresses the advantages of outward-orientation and export promotion and which emphasizes the heavy costs of import substitution.

Krugman outlines some of the reasons that have been identified as the advantages of the outward-oriented strategy: the ability to enjoy economies of scale by producing for a large world market, the greater ease of technology transfer, the productivity gains from learning by doing that follow the introduction of new manufacturing processes, and so on. Krugman himself has contributed in earlier work to the development of many of these ideas. The surprising part of Krugman's discussion is his scepticism about the ability of other developing countries to follow the examples of the East Asian economies. In Krugman's view, some countries simply have "It," and others don't, in regard to their ability to export industrial goods in world markets. Only those countries that have "It" can benefit from a shift to outward orientation. Krugman cites as a putative case of failure the example of Chile, which has liberalized trade but has not developed an industrial export base. Liberalization has instead spurred new sectors of nontraditional agricultural exports. (On the whole, despite Krugman's negative comments, Chile's recent economic growth is quite impressive, even though it is based on agricultural rather than industrial exports. Wages, employment, and living standards have been rising steadily for several years as a result of the new policies.)

I find Krugman's theory of "It" quite troubling. The theory rather casually divides the world between innate successes and innate failures, and seems to bolster the hoary myth that cultural superiority (or race or religion, according to some observers) can explain the economic success of some parts of the world and the failure of others. It was this attitude, after all, that fundamentally misled many observers in the 1950s into predicting that

Korea and other Asian countries could never succeed (since East Asian Confucian and Buddhist traditions were supposedly inimical to capitalism). Now, in the updated form, it is Korea that has “It” and Chile that does not.

I would rather have Paul look more systematically at the various economic and political factors that have contributed to the relative success of some countries and not others, without the appeal to a mystical “It.” In this regard, we can point to fundamental differences such as: the direction of economic policy over long periods of time (Korea’s export promotion strategy has been around almost thirty years; Chile’s has lasted less than half that time, in much more conflictive political circumstances); the endowments of the main factors of production in the various economies (e.g., land, labor, natural resources, educational attainments of the population); the distribution of income, with its effects on political stability and entrepreneurship (Latin America has much greater inequalities of income and wealth than do the Asian economies).

The relative supply of land versus labor in Latin America and East Asia is one of the most important differences between the two regions, a difference that has played an important role in their distinctive paths of development. It is a difference that Krugman fails to mention, surprisingly in view of the importance that economists have long attributed to the linkage of factor endowments and trade patterns.

In Hong Kong, for example, there are about 5,000 people per square kilometer (and in Korea, about 400 per square kilometer), whereas in Chile there are only 16 people per square kilometer. The vast availability of land per person in Latin America in comparison with the dense population in East Asia has naturally made Latin America a region of agricultural exports. Also, Latin America is resource rich (Chile has copper, Peru silver, Mexico and Venezuela oil), while most of East Asia is resource poor (the Southeast Asian countries of Indonesia, Malaysia, and Thailand are exceptions). Thus, it is natural, indeed virtually unavoidable, that Latin America would be an agricultural and resource exporter, while East Asia would not.

If it is true that manufacturing exports offer special benefits to an economy (through economies of scale, opportunities for learning, technological advances), then a large endowment of land and resources can sometimes be, paradoxically, a hindrance rather than a help to rapid growth. With Argentina’s productive pampas producing meat and grains for the world and Chile’s copper supplying much of the world’s needs for that metal, for example, the exchange rate in those countries has traditionally been too strong to give their manufacturers a chance to compete in world markets. Historically, it is only when copper and food prices are low in world markets, so that the peso is weak in Argentina and Chile, that manufacturers in those countries have been able to gain a tenuous foothold

in world markets. Ironically, subsequent commodity price increases have then squeezed the nascent manufacturing exporters out of business once again until the next commodity price collapse!

Of course disastrous trade policies and an unstable political environment added significant damage to the manufacturing export capabilities of Argentina, Chile, and most other countries in Latin America. Immediately after World War II, when Prebisch and Singer made their pessimistic forecasts of future commodities prices, the inward-looking process of import substitution (based on high tariffs, which punish potential exporters) added to the natural bias against manufacturing exporters. Until Japan and other Asian economies showed the way, there was little confidence among most development specialists that the poorer countries could possibly compete in the world market for manufacturers, even if they tried.

The battle over income distribution also played an important role in Latin America's choice of inward-oriented development strategy rather than promotion of manufacturing exports. Policies to make the exchange rate competitive and to lower tariffs would not only benefit new manufacturing exports but also the existing agricultural exporters. Since these exporters were part of the old and rich oligarchy (or at least were perceived to be so), political parties based on urban workers, such as the Peronists in Argentina, fought virtually all policies that tended to promote exports. Export promotion of any kind was seen as good for the rich and bad for the urban workers. This kind of distributional battle was virtually absent in the peasant-based East Asian economies, where urban workers had little political power.

With the benefit of hindsight, we can now identify a set of policies in land-rich Argentina and Chile that would have been consistent with the Prebisch pessimism about raw materials but that would also have allowed for the development of manufacturing exports. Rather than pursuing a policy of high tariff barriers and import substitution, policymakers could have taxed agriculture and natural resources (at a moderate rate), thereby limiting the dependence on primary commodities while at the same time encouraging labor-intensive manufacturing exports. In countries like Argentina and Chile, this combination of policies could well have helped to spur growth and improve income distribution at the same time.

Let me now turn to the debt crisis. What I miss in Paul's interesting discussion is the kind of power politics that has underlain most of the management of the debt crisis in recent years. Contrary to Paul's analysis, the debt crisis is not mainly a process of negotiation between debtor countries and their creditor banks but a process of negotiation between debtor countries and creditor *governments*, led by the United States. The United States and other creditor governments have set down the terms that

the debtor countries must follow. Those terms have been ridiculously harsh and thereby very shortsighted.

So far, the United States has insisted that the debtor countries continue to pay interest to the banks, even if that contributes to the collapse of the debtor country (note that Argentina, Brazil, and Peru, among others, are now experiencing virtual hyperinflations, in large part because of their debt burdens). These countries have continued to pay their debts, on the whole, because to do otherwise would be to risk a foreign policy rupture with the United States, which would threaten these countries in many areas other than finance, including trade relations and military security.

One easy way, therefore, to resolve the crisis would be for the United States government to state, simply, that it is no longer standing behind the banks and that it recognizes the need for the commercial bank debts to be renegotiated on more favorable terms. The banks would then be forced to come to new terms, since the main bargaining power of the banks comes not from their own leverage but from the active support of the U.S. government.

While serving in recent years as one of Bolivia's debt negotiators, I watched at close range how the process can work out this way. When the Bolivian economy collapsed in the mid-1980s and the U.S. government judged the situation to be sufficiently desperate, the U.S. government simply looked the other way when the Bolivian government suspended debt-servicing payments. The U.S. government continued to deal sympathetically with Bolivia's needs (e.g., by supporting an IMF agreement for Bolivia) despite the suspension of debt payments. When the banks realized that the U.S. government would not "enforce" their contracts with Bolivia, they entered negotiations with Bolivia. These were based on the notion that Bolivia required a fundamental reduction of its debt burden. By mid-1988, about half of Bolivia's debt has been canceled through Bolivia's repurchase of its debts from the banks at a very deep discount.

Krugman is undoubtedly correct that there are no easy solutions to the crisis and that all suggested policy alternatives to the current approach have serious risks. But I would strongly urge that the risks of the various new approaches (particularly those stressing debt reduction) are much less than the risks that confront us if we continue on the current path.* The risks of the current approach are a continuing descent of the developing countries into poverty and political instability, as well as the risks of large taxpayer expenses at the end of the road, as the creditor governments finally bail out both the banks and the debtor countries. Already many of the Latin

*I have shown the feasibility of some of the alternative approaches in "New Approaches to the Latin American Debt Crisis," a paper prepared for the Harvard University Symposium on the Debt Crisis, September 1988.

American democracies (such as Argentina, Brazil, and Peru) are in jeopardy over the sharp deterioration of their economies. It should be stressed that the alternative approach of debt reduction no longer poses any serious risks to the commercial banking system, since almost all banks are now out of danger with regard to their developing-country exposure.

DAVID E. BELL: I would like to introduce a different line of discussion at this point. What I want to do is tie the classification that Paul uses in his paper back to the discussion of development aid that we were having a little while ago. You all realize, of course, that development assistance and developing countries have come to refer to two different communities. Development assistance is concessional aid. This recent discussion has been about countries that do not receive concessional aid except in the case of a write-down of debt.

Twenty-some years ago, when Hollis and I were in AID, we began to distinguish to whom development aid in the traditional sense ought to go. We developed a theory on the basis of which development aid was a temporary investment process; when countries reached a certain stage of economic strength, development aid was to be brought to an end. Development aid terminated for Taiwan and Korea, for Iran, Mexico, and so on, in country after country. Development aid, therefore, was seen correctly as a temporary process. I refuse to accept the idea that some countries are wards, permanent basket cases. I personally know no such country. I think this theory of development assistance as a temporary investment process is entirely consistent with world reality and would fit well into a new formulation of a development assistance program.

It does not mean, however, that there would not be a lot of international economic issues, debt issues, trade issues, and the like that would have to be considered in different forums, on different terms. I think our terminology has not caught up with all that. The World Bank refers to all Third World countries as developing, whether or not they are the recipients of concessional aid. So this way of looking at differentiation among the Third World countries may be seen as a contribution to designing a stable development assistance program. But the terminology, the semantics, are blurred today; they have to be addressed.

NANCY BIRDSALL: I would like to comment on something that I thought was missing in the discussion of debt, particularly in Jeffrey Sachs's remarks. Let me preface this by saying that I am newly impressed with how extraordinarily confused I am about the whole business. The thing that I thought was missing was any discussion of the ability of these countries to make the internal adjustment changes that are required. The failure of stabilization policies, particularly in Brazil, for example, is critical. I would not agree that

the World Bank, for example, did not lend very much to Brazil recently, in the period of the moratorium, because there was some direct causal connection between the moratorium policy and reluctance to lend on the U.S. side, as opposed to the failure of stabilization efforts. I think the difference between Brazil and Bolivia is not only what you suggested in your remarks but also that Bolivia did take on some difficult internal adjustment policies, which made it easier for the concessional development flows to recommence. In the period of Brazil's moratorium, the constraint to lending in the lending program of the World Bank has been the difficulty faced by the Brazilian government in making the necessary policy adjustments, structural policy adjustments.

So I think it is not just a problem of negotiations between the countries and the other side—be the other side the bankers or the wider international community. I think there is a question of the ability internally to deal with the fiscal deficit problem, the internal debt problem, in Brazil and many other countries that have an external debt problem. That goes back to all of the other issues we have been raising about the role of government, good government, and to what development is all about.