
This book contains the background papers prepared for the World Bank's *World Development Report 1984* and used as the basis for Part I of the *Report* dealing with "Recovery or Relapse in the World Economy?" There are eight papers, an introduction and overview by the editors, and two appendices. Four of the papers were written by outside consultants and the remaining papers and appendices were done primarily by individuals with some current or previous affiliation with the Bank. The analysis and data generally reflect conditions through 1983.

The papers address a variety of current and vital issues in the world economy, including the stagflation and decline in productivity and net savings in the industrialized countries dating from the 1970s, the slowing down of world trade, the stress on the international banking system and the adjustment problems associated with the debt crisis in selected developing countries, and the crowding out of global savings as a result of the public sector policies being pursued in the industrialized and developing countries.

To place the recent events in historical perspective, it is of interest to compare the effects of the world recessions of 1974–1975 and 1981–1982 with what happened in the Great Depression of the 1930s. In his paper reviewing the historical record, Angus Maddison notes that the Great Depression was much more severe than were any downturns that have been experienced since World War II. There were staggering declines in output and employment in the major industrialized and developing countries during the 1930s, and the international monetary and trading system in effect disintegrated. Debtor countries were unable to service their foreign borrowings because of the substantial decline in their export earnings and worsened terms of trade, and there was considerable capital flight. As a consequence, defaults on foreign loans were widespread. These sobering events fortunately have not been repeated in the postwar period as the major industrialized countries have come to realize the importance of international cooperation and consultation and the need for effective domestic stabilization measures. Yet, there have been serious enough macroeconomic policy errors during the 1970s and 1980s in both industrialized and developing countries, so that the experiences of the 1930s do not seem altogether remote.
In seeking to explain the reasons for the slowdown of the world economy and the problem of stagflation in the 1970s, Gottfried Haberler has occasion to review the alternative macroeconomic explanations offered by the Keynesian, monetarist-rational expectations, and classical models. He faults the Keynesian model mainly because it does not allow adequately for inflationary expectations and because its proponents seem relatively unconcerned about the inflationary implications of their recommended macropolicies. He is also critical of the monetarist-rational expectations model because it gives insufficient weight to the importance of wage and price rigidities. Haberler is thus inclined to what he calls the traditional conservative or classical position according to which wage rigidity, real wage resistance, and real wage push represent serious impediments in attaining price stability and relatively high employment levels and rates of growth. The issue, of course, is how to achieve these objectives, and it is Haberler’s view that it requires both monetary and fiscal tightness coupled with the removal of existing market imperfections and government-induced distortions in order to promote more effective adjustment at the micro level.

The role of public expenditures and implications of government deficits are analyzed in two especially interesting and insightful papers by Deepak Lal and Sweder van Wijnbergen and by Lal and Martin Wolf. In the first of these papers, attention is drawn to the relation between rising public sector deficits in both the major industrialized and the developing countries and the possible global shortage of savings. Prior to the 1980s, there were marked increases in real wages in the industrialized countries coupled with a growing commitment of governments to promote social justice by measures involving the transfer and redistribution of income. Budgetary pressures were thus increased in many countries due especially to greater expenditures on social security and public health. Government revenues were not increased commensurately, however, so that significant budget deficits were encountered. This in turn may have had crowding-out effects on domestic investment and possibly future detrimental effects on productivity and growth because of a reduction in the long-run capital stock. In the developing countries, increasing urbanization and demand for social services led to greater public expenditures and foreign borrowing. Because of fiscal weaknesses in many of these countries, government revenues could not be increased and budgetary deficits were monetized, and significant inflation then occurred.

Lal and van Wijnbergen suggest that we should view the global financial system as integrating the savings and investment relations in the major industrialized and developing countries and thus determining world real interest rates. They argue that in the 1970s there was a decline in the marginal product of capital and the demand for investment at a time when global savings did not fall markedly. As a consequence, world real interest rates were exceptionally low by historical standards, and accordingly there were great incentives
for developing countries especially to engage in foreign borrowing following the first oil shock of 1973–1974. This situation changed markedly in the 1980s with the adoption of disinflationary policies and a fall in expected rates of inflation in the industrialized countries. The accompanying collapse in world oil and other commodity prices in the face of a sharp increase in world real interest rates has made it especially difficult for many developing countries, especially in Latin America, to service their foreign debts.

Risk considerations arising in connection with developing country debt are analyzed by Robert Lawrence. In his view, the international system severely underestimated the effects of systemic risk. The borrowing countries ignored the risks of maturity mismatch, fluctuations in their income due to exogenous demand and supply shocks, effects of exchange-rate fluctuations, and fluctuations in interest rates. The international lending banks underestimated the possibility of default risk and difficulties that borrowing countries might have in servicing their debts. The lenders also did not take into account the potential dangers to national banking systems posed by their nonperforming foreign loans. Granting all of these considerations, Lawrence notes that the key systemic issue was the probability of major synchronous losses arising from the foreign loans. While this probability was judged to be relatively low by both lenders and borrowers in the 1970s, the worst-case scenario was realized in the early 1980s with the onset of the deep recession, unprecedently high real interest rates, the appreciation of the U.S. dollar, and the collapse of commodity prices. While the system is thus very vulnerable to default, Lawrence believes that innovations in the financial markets are likely to result in the diversification of risk and that long-run global solutions to the debt crisis are not warranted.

The adjustment experiences of the developing countries in the 1970s and 1980s are analyzed in papers by Pradeep Mitra, Alan Gelb, and Larry Sjaastad et al. Mitra presents simulation results based on an open economy macromodel in which the post-1973 output levels are calculated using parameters prevailing in 1963–1973 and then compared with actual output levels. The modes of adjustment to the post-1973 shocks included changes in trade, domestic resource mobilization, investment slowdown, and additional external financing. The countries are then grouped according to the broad contours that characterized their experiences.

Gelb's paper focuses on the adjustments in selected oil-exporting countries (Algeria, Ecuador, Indonesia, Iran, Nigeria, Trinidad, and Venezuela). He notes that these countries allocated the bulk of their increased oil revenues to domestic investments, which were often of large scale and in the public sector. The subsequent collapse of world oil prices caused great difficulties in economic management since the investments could not be sustained. Gelb concludes that these countries would probably have been better advised if
they had saved more and relied on market criteria in making their investment decisions.

The paper by Sjaastad et al. is best viewed as a series of case studies of the major Latin American debtor countries (Argentina, Brazil, Chile, Mexico, and Venezuela). They call attention to the coincidence of a number of quite independent phenomena that were mentioned above as triggering the debt crisis. In reviewing the experiences of the individual countries through the end of 1983, they note that there is some evidence that the debt crisis forced governments to rely more heavily on domestic inflation as a source of finance since they were unable to effect increases in taxes and/or reductions in government spending. Nonetheless, considerable adjustments in the domestic economy and foreign sector have taken place in the Latin American countries. The difficulty, however, is that these adjustments have been detrimental to domestic income and employment and that the changes in the external sector have involved a reduction in imports rather than an increase in exports. They view the way out of the debt problem as having the lending banks roll over the present outstanding debt in order to bring the maturity profile into a more manageable configuration.

In their paper entitled "Debts, Deficits, and Distortions," Lal and Wolf reiterate the main theme of the volume, which is that there is a commonality in the problems of both the industrialized and the developing countries as reflected in the unsustainable buildup of public debt, fiscal deficits, and policy-induced distortions in the market mechanism, and that there may be a genuine problem of the global crowding out of savings. It is therefore imperative to seek improvements, especially in the design and conduct of fiscal policy, and to introduce measures that will enhance the efficiency and flexibility of goods and factor markets. These changes will require a redirection of social policies and possible reductions in public expenditures and the removal of many existing market impediments. Such changes will certainly be difficult to implement because they involve some potentially far-reaching reordering of social priorities and institutions. Lal and Wolf maintain that the observed deterioration of economic performance has been the consequence of misguided national policies rather than changes in underlying economic conditions. If they are right, it is therefore of great importance to initiate and sustain a different course of action because the current direction of policies in both the major industrialized and the developing countries seems destined to lead to the further impoverishment of the world economic community.

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