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Prospects for the Developing Countries

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PROSPECTS FOR DEVELOPING COUNTRIES

I wish to discuss with you today the general prospects for developing countries in order to provide a background for considering some of the specific problems of Pakistan. I last gave a talk in Karachi ten years ago, on the occasion of a gathering of the advisers of the Pakistan Institute of Development Economics, at a time when the Third Five Year Plan was just beginning. I made a rather optimistic assessment of Pakistan's prospects of success and some alternative projections for the future. Before coming here today, I have gone back over that assessment to see how much of it appears valid, and what seems notably different about the situation now. This review shows improvements in some respects and deterioration in others.

I. 1950—1970: Expanding Trade and Growth

We used to think, and perhaps not wrongly, that the essential feature of development was growth. Most of the development plans of the 1950s and early 1960s, including those of Pakistan, were based on this principle. The growth of the economy, it was said, must be rapid, and no harm would be done by following the model of the industrialized West. During all of this period, countries pursued their development plans in an international environment that was relatively stable. With steady growth in the industrialized countries, world trade was expanding rapidly. By increasing their exports, most of the developing countries were able to reduce the amounts of foreign capital they needed to expand imports and investment. Their economies grew somewhat faster than many, including myself, had predicted—at

between 5 and 6% a year—while inflows of foreign capital were rarely much higher than 2 to 3% of GNP.*

But towards the end of the 1960s there were rumblings of discontent. Growth expectations had been achieved; average income per head in many developing countries had increased by 50% or more; but it was becoming increasingly clear that such average figures bore little relation to the living standards of large numbers of people in poverty. Growth had been marked by worsening economic dualism, whereby the modern sector expanded more rapidly than the traditional, absorbing more investment, generating more savings, increasing its output more quickly. The linkages between the modern sector and the rest of the economy were commonly very weak, and thus people who were not associated with the modern sector—who, for example, were engaged in traditional agriculture, or who lived in regions unaffected by modernaization—benefited far less than the average. I need hardly elaborate on this theme in a country where it has been much debated.

With the economic events of the 1970s, we have been made far more aware that the perception of unequal advantage has an international dimension too. If we are to analyze the long-term prospects of developing countries, including those of Pakistan, we must try to explain the consequences of the economic crisis of 1973-74 and to examine whether different countries' efforts to overcome it have reinforced or retarded their development.

II. Economic Crisis, 1973-74

The major elements of the recent crisis are well known and have been widely discussed. If I may recall the atmosphere of 1974, there had been an unprecedented boom in the advanced countries, whose economies had been growing at what turned out to be unsustainable rates exceeding 6% per year. As a result,

* An assessment of the experience of the 1960s is given in Chenery and Carter, "Foreign Assistance and Development Performance, 1960—1970", *American Economic Review*, May, 1973.

the prices of primary products relative to manufactured goods had risen higher than at any time since the Korean war twenty years earlier. At this point, it would have been logical for the price of oil to also go up, regardless of whether or not concerted action was taken by producers. In the event, these economic forces coincided with the Middle East crisis, and oil prices increased by a factor of four. As a result, the OPEC countries' oil revenues increased by about US $ 80 billion per year, an amount equivalent to 10% of the total value of world exports. The import bills of the oil importing countries went up by some 10%, purely as a consequence of this price change. The OECD countries' balances of payments were severely disrupted at first, but in the recession which followed they managed to reduce their deficits by reducing economic growth. Since then, their collective deficit has been small or non-existent. Deficits in England and Italy have been offset by surpluses in Germany, Japan and the United States. The non-oil exporting developing countries—let us call them non-oil countries for short—have had nothing like the rich countries' freedom of choice. Their current account deficit increased from US $ 10 billion in 1973 to US $ 30 billion in 1974, and has been between US $ 30 and US $ 40 billion ever since. A substantial part of this continuing deficit has been caused by the recession of the OECD countries, which has had an even greater impact than the initial effect of the rise in oil prices.

Pakistan was not at first among the most seriously affected countries because the prices of its primary exports had been continuing to rise. But by 1975, its terms of trade had worsened, and its deficit had risen from US $ 130 million to something like US $ 1,200 million, equal to half of its total imports. Many factors contributed to this increase in debt: though Pakistan's experience was fairly typical for the non-oil countries in that its total import bill rose by some 10% (an increase that amounted to 2% of its GNP), its increased expenditures on oil accounted for a relatively small part—only US $ 250 million. I shall return to this question later.

How far the world recession was caused by the increase in the oil price is still a matter of debate, but one thing is clear: the oil importing countries as a group can only reduce their deficit as the OPEC countries expand their imports and reduce their surpluses. In the meantime, borrowing has enabled most of the developing countries to avoid a reduction in their imports and GNP and has also cushioned the effects of the OECD recession. At the international level, the action most needed is to complete the recovery of the OECD countries and thus enable the developing countries to expand their exports and reduce their deficits to more normal levels.*

III. The Adjustment Process

How have the developing countries been adjusting to the fall in their import capacity and lower growth of income? In the short run, demand had to be restrained, through curtailing consumption, or investment, or government spending, or some combination of these. But to try to reduce the enormous balance of payments deficits immediately would have meant such a loss of growth that countries resorted to borrowing, from whatever sources were available and generally on harder terms. Of the increase in their debt of about US $ 30 billion per year (since 1974), about four-fifths was contracted on relatively hard terms, from the OPEC countries; from the Euro-currency market; and from the World Bank and the IMF. The remaining US $ 5 billion was borrowed on soft terms, both from OPEC and OECD countries.

In the long run, if growth is not to be permanently impaired, structural adjustments in the payments deficit have to be made through reducing the need for imports, modifying domestic consumption patterns and diversifying and expanding exports. But countries differ greatly in their ability to borrow and in the other policy options open to them. The poorest countries—those

* I have discussed this problem at greater length in "Restructuring the World Economy", *Foreign Affairs* (53), (January, 1975).

with per capita incomes under $ 200, which people are now calling the Fourth World—have had no large sources of external finance save a limited amount of soft loans and the IMF oil facility. A high proportion of their imports already consisted of food and fuel, and the crisis came at a time when their terms of trade had been worsening steadily for several years. (Between 1973 and 1975, their terms of trade deteriorated by about 20%). Largely because they had no immediate way of compensating for this decline in purchasing power of their exports, they have had virtually no increase in per capita incomes since 1970.

In contrast to most of the low income countries, the situation of Pakistan has been eased to a considerable extent. Its ability to borrow from OPEC countries has probably "bought" about two years of time, but eventually it will have to complete the same adjustment process as others.

Even disregarding the changes in the world economy, the fact that over the past 5 or 6 years there has been little or no growth in per capita income and consumption in Pakistan is not surprising. The creation of two separate countries obviously involved large changes in the productive structures of both, a reordering of trade, a large shift in ownership and other changes in the economic structure. But there have also been other disruptions. Pakistan's terms of trade are by now about 15 to 18% worse than in 1973. The amount it has borrowed during the last several years is more typical of the more affluent developing countries than of a poor one: 5 to 8% of its GNP. Pakistan has thus been financing more han half of its total investments from foreign borrowings. These are exceptional proportions by any standards. Exactly how large a flow will be manageable in future of course depends on the terms of the loans, but certainly the ratio of foreign borrowing to GNP will need to be reduced. To do so, as I gather is one of the aims of the new Six Year Plan, will require significant changes in trade policies. Quite a large part of the trade deficit can be attributed to increases in import

volumes. In future, export earnings will have to grow faster than imports. Moreover, savings will have to grow very much more rapidly than investment, rather than continuing their drastic decline as a share of GNP. It will also be necessary to broaden the base of development, giving more emphasis to raising the productivity of small producers. Changes in agricultural price policy will be called for too. Subsidies to consumers are already being reduced, but producers will need to be given enough incentives to increase output not only to meet domestic demand but also for export. This implies that agricultural prices must be allowed to rise to international levels.

Pakistan has the physical resources necessary for a successful completion of the transition to a more sustainable pattern of growth. Its agricultural sector has more potential than most of its neighbours, and technically it would be quite feasible to have agricultural output growing at 5% a year for the next decade, through the use of increased irrigation and fertilizer, pesticides and so forth. Whether this can actually be achieved depends largely on price policies and administrative capability.

Whereas in the case of agriculture I think it is fair to say that most of the problems are on the supply side, in industry it could equally be said that the main problems are those of demand. This is not true only of Pakistan: throughout the sub-continent, industrial growth has been slow less because of the structure of industry than because domestic demand has not been expanding and export incentives have been inadequate. In order to correct other problems, growth of income has had to be slowed down and this has curtailed the growth of the market for industrial goods.

Though Pakistan will face difficult problems of structural readjustment in regaining the growth rates of the late 1960s, of 6% per year, it is hard to point to any one of them which seems insurmountable. But the question is whether the government will

perceive this overall strategy as necessary and take the steps required to carry it out.

In other poor countries, the price changes which were necessary to reduce consumption and imports, and the measures necessary to increase investment and to encourage production for export have had to be put in place more quickly than in Pakistan. This has given rise to a certain amount of inflation and consumers have inevitably suffered serious hardships. In most of the poorer countries, such as India, Sri Lanka, and Tanzania, economic growth has been reduced, but a better basis has been established for future development.

The richer developing countries—mainly those of Latin America, the Mediterranean basin and East Asia—have generally been more fortunate. They have had greater access to private capital markets and—though they ran large deficits—they were able to sustain their imports, finance their needs for continued growth and expand their exports. Even though the economies of the OECD countries were not growing at all, these middle income developing countries have managed to sustain growth at 4 to 5% a year. The fact that their debt is increasing is of secondary importance, so long as they can resume rapid growth and continue expanding their trade. Since they are able to earn sufficient foreign exchange to service their debt, their main problem will be one of debt management.

Taking the period of 1974-76 as a whole, there has thus been a large run-up in the borrowings of all non-oil developing countries, though limited in the poorer ones by their lack of access to capital markets. The adjustment process in the world economy will consist of a gradual reduction of this amount in relative importance, as economic growth is resumed. By 1981 I think that we can look forward with some confidence to a return in most developing countries to a level of net capital inflow that is no higher than the levels of 2-3% of GNP that existed in the

1960s. Some countries will still have larger debt burdens than at the beginning of the 1970s, particularly those that do not focus on expanding exports.

Though there have been severe strains on individual countries, the recent crisis has not resulted in the collapse of the international economic system. It is worth noting that in its provision of funds to developing countries which were creditworthy, the private banking system has shown itself far more flexible than had been anticipated and has facilitated a shift of public financing to the poorer countries where the need is greatest.

Let us look for a moment at the effects of these events on future development prospects. One of the objectives of the United Nations Second Development Decade (1971-80) was to achieve an average annual growth rate of 6% for all developing countries. That overall target may well be achieved by 1980, but in a form very different from what was originally envisaged. While a relatively small number of countries will have grown very fast, a billion people are living in countries which will have had little or no growth in per capita income over the whole of this decade.

Not only have the effects of the recent crisis been worse for poor countries than for rich; within countries, the poor have generally suffered more than the rich, who are much less vulnerable. Although the statistics on income distribution are very sketchy, I feel relatively confident in saying that the restructuring which is taking place is not improving the relative position of poor people or of poor countries. Thus, once the balance of payments ceases to be the main preoccupation of governments, the problems of poverty and the distribution of income will demand even more urgent attention than in the past. It is to these issues that I want to devote my concluding remarks.

IV. Longer Term Prospects and Policy Options

Since the slowdown in growth of GNP has not been accompanied by a slowing of population growth, there are larger

numbers of people in unproductive occupations than there would have been with more rapid economic growth. This means that the dualistic features of growth have been accentuated, in Pakistan as in other countries.

In such circumstances, the reduction of poverty and improvements in income distribution require a deliberate strategy. What has experience taught us about the design of such a strategy? First, in poor countries there is little promise in attempting to equalize the distribution of income through subsidizing the consumption of the poor. Even if a government took the political risk of imposing extremely heavy taxes, it is unlikely that the funds so generated would suffice to raise the incomes of the poor very substantially. But even more important is the cost of such a transfer policy in terms of investment forgone. The largest income transfer programme I know is that of Sri Lanka, which was designed to make the poor better off through subsidies on food and education. After two decades of this policy, GNP growth was considerably reduced through the diversion of resources from investment. Arguably, almost everyone is now worse off than they might have been otherwise. Though income transfers can improve the welfare of the poor in the short run, their cost in terms of forgone investment and slower growth is too high to make them viable on a large scale for long periods. A concern with distribution is of little use if there is not much increase in income to distribute.

The opposite extreme—maximizing growth—is also unlikely to be sufficient. The evidence from several countries in the 1960s tends to confirm Kuznets' hypothesis that as poor countries grow, the distribution of income normally gets worse before it gets better. However, there are several examples which suggest that this tendency can be counteracted by deliberate measures. Most notable are Korea and Taiwan, both of which have been growing at 9 or 10% per year for the last 10 to 15 years. While income distribution was already fairly good as a result of the land reforms

of the early 1950s, it has become demonstrably better. In general, it appears that while the poor will usually be better off with high growth than with low because of the effect on employment and wages, their welfare can be substantially enhanced by land reform and other measures to spread the benefits of increasing productivity more widely.

I think it is also important to dispel the view that long-term growth must necessarily be sacrificed to improve distribution, or vice versa. In the short run, there may indeed be such a trade-off. For example, redirecting public investment to build up the capital stock available to the poor is likely to involve some sacrifice of output—investments in human capital take longer to mature. But whether there is a conflict or not also depends upon one's values: for example, is the welfare of society reduced if GNP growth is reduced from 8 to 7-1|2%, but the poor are now sharing more widely in that growth? If one assigns as much weight to raising the consumption of the poor as the more affluent, the welfare of the society can be increased more rapidly, even with somewhat lower increases in GNP.*

There are very few countries nowadays which would draw up a development programme that only aimed to maximize growth. But one of the main problems in designing a strategy combining substantial growth with a better sharing of the benefits is that there are so few successes for us to learn from. We know a good deal by now about the prescriptions for growth: ingredients such as capital formation, development of human capital, balanced investment, which seem to be necessary in communist and capitalist countries alike. But it is difficult to know in political and social terms how best to combine growth with a redirection of investment, and a broadening of access to education, health and various other public services. Many research groups (including

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* This point is elaborated in Ahluwalia and Chenery, "A Model of Distribution and Growth", in Chenery et al, *Redistribution with Growth*, Oxford, 1974.

that in the World Bank), as well as many government policy units are examining what the mechanisms should be. At present I can only speculate where the analysis is leading to without laying down firm conclusions.

To comment on a question which is being debated in Pakistan at the moment, it seems to me that making the poor more productive will have little to do with whether the means of production are private or public. In Turkey, Mexico, Brazil and other mixed economies, the state industrial enterprises in fact behave in much the same way as the private sector: they over-invest in capital-intensive technologies and generally make little contribution to employment. While there may be good reasons for state ownership of industry—particularly heavy industry, which is characterized by economies of scale and needs large amounts of capital—this has not been a solution to problems of income distribution. State enterprises usually have preferential access to capital and foreign exchange. In these circumstances there is a grave risk that other, smaller producers who could contribute more to employment may be straved of these essentials. The moral from the experience of mixed economies seems to be that if state enterprises are not to become a burden on the economy, they must not be afforded preferential treatment in the cost of capital, access to imports, or output pricing.

Governments have typically taken the line of least resistance by concentrating on large scale enterprises in the modern sector, which if they are not government-owned can at least be organized and controlled comparatively easily. But to improve the income distribution and spread the benefits of growth more widely, the much larger number of people who are employed in small scale activities need to have equal access to productive inputs. The heart of the poverty problem lies not so much in the form of ownership as in devising institutions which will reach these producers, both in agriculture and in manufacturing.

Development planning is more complicated than we used to think. It is necessary to analyze the process by which income distribution is generated as a part of the overall process of development, and a plan has to take as much account of its impact on income distribution as of its impact on the balance of payments or on the growth of GNP. Hopefully before too long we shall not have to regard the availability of foreign exchange as the main constraint on development. Some means of spreading the benefits of growth more equitably—by region, by country, and by groups of people within countries—will have to be found if the next decade of development is to be more satisfactory than the last.