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How Did the Asian Countries Avoid the Debt Crisis?

Ishrat Husain

Economic stability, sound macroeconomic policies, and appropriate microeconomic incentives hold down a country's external debt burden. Most of the Asian countries pursued prudent macroeconomic policies, paid attention to price stability, and minimized price distortions. These countries avoided the overvalued exchange rates and uncompetitive interest rates that caused massive capital flight from Latin American and some African countries.

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This paper -- a product of the Debt and International Finance Division, International Economics Department — is part of a larger effort in PRE to understand the relationship between macroeconomic policies and external indebtedness of developing countries. Copies are available free from the World Bank, 1818 H Street NW, Washington DC 20433. Please contact Sheilah King-Watson, room S8-040, extension 31047 (26 pages). October 1991.

If a country's macroeconomic policies are generally sound and microeconomic distortions minimal, sporadic episodes of overborrowing or inadequate attention to the terms, maturity, and currency composition of external debt will generally not make a difference in its debt picture.

But acts of indiscretion in external debt management tend to be magnified when those basic policies are inadequate. The recent upturn in Latin American economies — particularly in Chile, Mexico, and Venezuela, which are now successfully pursuing macroeconomic adjustment — supports the validity of these findings.

How did the Asian countries avoid the debt crisis? Husain answers that question partly by contrasting their behavior with that of 12 highly indebted Latin American and African countries studied by the Bank in the mid-1980s.

The Asian countries, with a few exceptions, pursued an outward-oriented strategy and prudent macroeconomic policies. They made quick adjustments to external shocks by switching expenditures, expanding exports, and curtailing consumption. Most borrowed and locally raised funds were invested in productive uses, improving the economy's ability to repay the debt. These countries relied heavily on domestic savings and resources to finance investments. They did not allow crises to drift or be aggravated.

In China, India, and Korea, investment rates were relatively high, financed mostly from domestic savings; foreign loans were use judiciously, as a complement to domestic savings. Foreign capital accounted for only 2 to 3 percent of GDP in these countries, although investment rates averaged 30 percent of GDP.

By contrast, the Latin American governments expanded external borrowings to offset the effects of external shocks. In Brazil, foreign resources were substituted for domestic savings to support an import substitution strategy; in Mexico, fiscal deficits were financed by external borrowing.

At the same time, the residents of these countries transferred billions of dollars abroad. Husain attributes this massive capital flight to overvalued exchange rates and uncompetitive interest rates. These were intended to curb inflation but instead eroded creditworthiness because of their depressing effect on exports and savings.

Argentina, Mexico, and Venezuela — which experienced the massive flight of private capital while they were stepping up external borrowing — courted trouble with debt servicing, because much of the borrowed money was not invested in high-return projects. That flight capital has begun to return to Mexico and Venezuela, both of which embarked on successful economic reform in 1987.

How Did the Asian Countries Avoid the Debt Crisis?

by
Ishrat Husain

Table of Contents

Ishrat Husain[1]
The World Bank, Washington, D.C.

INTRODUCTION

In the development economics literature, there is a general consensus that the less developed countries will normally incur current account deficits and remain structural capital importers until they emerge from underdevelopment. It is also true that the bulk of the financing of these deficits would be provided by net capital inflows that give rise to external indebtedness. After all, that is how most of the developed countries of today achieved their growth. So, there is nothing intrinsically wrong with external borrowing per se. The crucial question is how best should developing countries manage external debt without plunging themselves into a crisis.[2] This is by no means an easy task as it involves some important trade-offs that balance the positive effect of external borrowing with its adverse affect on debt accumulation. The link between borrowing and growth is quite complex. On the one hand, external financing enables the borrowing country to achieve higher levels of imports and investment than can be warranted by domestic savings alone. On the other hand, to be able to fully service the debt when it falls due, the borrowing countries should have generated reasonably high growth and in turn trade and saving surpluses. If this link between higher levels of imports and investment does not transmit itself into high growth in income and exports then the borrowing countries face serious difficulties. Most of the academic and popular discussion in recent years has exclusively focussed on the origin and factors contributing to the debt crisis, the behavior and responses of highly indebted countries in Latin America and Africa, the bargaining between these countries and their creditors and the impact of debt overhang on the economic conditions of these countries. Very little has been said about the 60 countries or so that were able to avoid plunging into this crisis and able to strike the trade-offs required. This paper attempts to fill this gap in the literature and reviews the experience of external debt management of Asian developing countries during the past twenty years, compares this with the highly indebted countries and draws some lessons for enhancing our understanding of the management of external debt.[3]

As the region contains a variety of countries with different characteristics, endowments, and economic structures, it is useful to provide a typology of Asian developing countries on the basis of their income and debt burden.

The World Bank classifies countries in three categories: high income (more than $6,000 per capita income), middle income ($581 - $5,999) and low income (less than $580). Hong Kong, Singapore, and Taiwan

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[1] The author is Chief, Debt and International Finance Division, World Bank. The views expressed in this paper are those of the author's and should not be attributed to the World Bank, its Board of Directors, its management or any of its member countries. The author has drawn freely from a number of internal Bank studies in the preparation of this paper and he wishes to thank Mr. Ning Zhu for his assistance in preparing the statistical tables.

[2] For a survey of the literature on the relationship between external debt and growth in developing countries, see McDonald, D.C. (1982), "Debt capacity and Developing Country Borrowing," IMF Staff Papers 29 (4).

[3] The other study which attempts to make a comparative analysis of external debt and macroeconomic performance is Jeffrey Sachs, "External Debt and Macroeconomic performance in Latin America and East Asia," Brookings Paper on Economic Activity 2. (1985). That study covered six Latin American and four East Asian countries and was limited up to the period 1983. The analysis was a very useful exposition of the political economy of Export-led and Import-substitution strategies and an explanation of the differing exchange and trade regimes in Latin America and Asia

income), middle income ($581 - $5,999) and low income (less than $580). Hong Kong, Singapore, and Taiwan fall in the high income country and are excluded from the "developing country" group as the term is applied only to low and middle income countries.

This paper focusses on four sub-groups of Asian developing countries: (a) the ASEAN-4(Indonesia, Malaysia, Philippines and Thailand); (b) South Asia (c) China and (d) Korea. The ASEAN-4 and Korea are middle income countries while South Asia and China belong to the low income category.

The data for Asia shown in this paper therefore refer to this sample of ten countries, which accounts for 98% of the GNP and 97% of total debt, and 94% of the population of the region.Lack of reliable data on Afghanistan, Myanmar, Kampuchea, Lao P.D.R., and Vietnam forced the exclusion of these countries from the present study. Nepal, Bhutan, Maldives and the Pacific Island economies are relatively free from pressures of a debt burden and have also been excluded.

An objective measurement of the severity of debt burden when applied to developing countries in Asia, indicates that the Philippines and Myanmar are the only two countries in Asia which are severely indebted (out of 46 developing countries) while Indonesia, Bangladesh, Sri Lanka and Pakistan are moderately indebted [4].

How has the debt burden evolved in the Asian countries in comparison with that of Latin America? The total external debt of these ten Asian countries in 1990 was $307 billion. India and Indonesia were the largest debtors owing debt in excess of $50 billion each, followed by China, the Philippines, Thailand and Pakistan. Debt service ratios of only three countries--Indonesia, India and Philippines--exceeded 30 percent. Latin American debt outstanding in 1990 was $429 billion. Brazil, Mexico, Argentina and Venezuela were the largest debtors and twelve out of twenty severely indebted middle income countries belonged to this region.

It is interesting to note that the average annual growth rate in debt of East Asian countries during the sub-periods 1973-80 and 1980-87 has been higher than that of Latin America (see Table 1). Despite the more rapid accumulation of debt, all other key debt indicators except Debt/GNP remained stable or declined for Asia, while those in Latin America worsened despite repeated reschedulings and arrears accumulation (see Table 2). The improved debt indicators of Asia in fact reflect the underlying strong economic performance of the countries in this region.

How has the economic performance of the two groups of countries varied? Table 3 presents the comparative picture for three sub-periods 1965-73, 1973-80, and 1980-87. The first sub-period which is characterized by steady and stable economic conditions shows that the differences in the performance of the two groups were not that large. The second sub-period captures the effects of the exogenous shocks and turbulence suffered by the developing countries, while the third sub-period depicts the differentiated response and adjustment to these shocks. In the 1980s, Asian incomes grew more than twice as fast as in the rest of the world, and exports expanded at about twice the rate of North America and Europe.

Management of external debt can be influenced by the international economic environment, domestic economic policies and portfolio management decisions. It would be useful to recapitulate, as a backdrop, the international economic environment in which the developing countries had to manage their external debt.

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[4] World Debt Tables 1989-90 presents the classification of the countries and the definitions of the severe and moderate indebtedness. Severely indebted countries are defined as countries in which three of the four key ratios are above critical levels: debt to GNP (50 percent), debt to exports of goods and services (275 percent) scheduled debt service to exports (30 percent) and accrued interest to exports (20 percent).

INTERNATIONAL ECONOMIC ENVIRONMENT

During the decades of the 1970s and 1980s, four features of the international economic environment particularly affected the development performance of developing countries.

The first of these was relatively slow growth in industrialized countries. The annual growth of real GDP of OECD countries slowed down considerably from 4.1 percent in the 1960s to 2.5 percent in the 1970s. The recovery that was expected for the 1980s failed to materialize.

Second, the prices of primary commodities fell sharply; nominal prices were highly volatile during the two decades. Real interest rates are believed to be inversely correlated with prices of non-fuel commodities, and real interest rates, particularly in the 1980s, were relatively high compared to the earlier decades.

Third, the movement toward free-trade policies, sustained since the late 1940s by successive rounds of tariff reductions under the auspices of the General Agreement on Tariffs and Trade, came under serious threat in the mid-1970s. Successive adjustments in the Multi-Fibre Arrangement, and the proliferation of voluntary export restraints and non-tariff barriers, affected a growing proportion of the trade in manufactured goods between OECD and developing countries. In agricultural trade, already heavily protected, barriers in OECD countries became even more onerous during the 1980s.

Fourth, the breakdown of the Bretton Woods system of fixed exchange rates in the early 1970s made macroeconomic management much more complex than before for developing countries, which now had to adapt to sharp fluctuations in exchange rates among major currencies.

For all these reasons, the global context during the 1970s and 1980s was in sharp contrast to that of the previous 20 years. But a distinction has also to be drawn between the 1970s and the 1980s. The 1970s witnessed oil price hikes, with their profound repercussions throughout the world. Efforts were made to finance the much-enlarged balance of payments deficits of oil-importing developing countries including two oil facilities at the IMF. Private commercial bank lending to developing countries expanded phenomenally. In addition, there was a big increase in official development assistance, partly from petroleum exporting countries.

In many ways the 1980s had quite a different character. The financial and economic turbulence of the decade had a pervasive adverse impact on development generally. For OECD countries experiencing double-digit inflation, containment of price levels in the 1980s became a key aim of economic policy, overriding the earlier emphasis on maintaining full employment. The strict monetary policies adopted by industrial countries in the aftermath of the inflationary period of the late 1970s had a noticeable effect on demand and prices for primary commodities from developing countries. Prices of commodities other than fuel fell further; their average level for the decade was 35 percent lower than in 1980. Developing countries' exports of manufactured goods volume had sustained very rapid growth of 13.4 percent a year in 1974-80, registered a major setback. Such exports increased by only 9.4 percent a year during 1981-87. In value terms, the growth of these exports slowed even more markedly - from 14 percent a year in the earlier period to only 4.7 percent a year in 1981-87.

The most dramatic feature of the international economic environment in the 1980s was of course the debt crisis. In international capital markets, real interest rates rose to very high levels. Averaging 5.85 percent during 1980-89, they were twice as high as in the 1960s, and nearly six time as high as in 1974-79. As debt difficulties grew, international commercial lenders stopped most voluntary lending to the highly indebted developing countries. Gross commercial bank lending to all developing countries dropped from $52 billion in 1981 to far short of $10 billion a year at the end of the 1980s. The gross flow of private foreign direct investment to developing countries peaked in 1982 and then declined sharply in subsequent years in contrast to high growth recorded in OECD countries throughout the decade. Many developing countries that had received large net resource transfers from abroad in the 1970s now had to pay very high proportions of their export earnings to service debt.

The external circumstances facing Asian countries in the 1970s and early 1980s were no different from those faced by the Latin American and African countries. Oil price shocks, low cost of funds, falling commodity prices and recession in the industrial countries stimulated the demand for external borrowing while the excess liquidity of commercial banks pushed the supply of these funds. A proxy variable used for capturing the influence of external environment is the terms of trade movement. The data shows that the terms of trade of Asian countries declined (0.6 percent per year) during 1973-82 compared to an increase (3.8 percent) for the highly indebted countries. The volatility in the terms-of-trade was, however, considerably higher for the latter group of countries. Sachs[5] who estimated the real income effect of terms-of-trade change for the period 1979-85 did not find any significant differences between the two groups of countries. His broad conclusion based on calculation of combined effect of the terms-of-trade and interest rate shock was that macroeconomic performance and the need to reschedule were not closely tied to the magnitude of the external shocks as a proportion of GDP. Donovan's study[6] of a larger sample of middle-income developing countries also found that the magnitude of terms-of-trade movements was not markedly different for groups of reschedulers and non-reschedulers.

The main question explored in this paper is: Given the same international economic environment and no differences in the magnitudes of external shocks, why have the Asian countries avoided the debt crisis while the Latin American and African countries have been embroiled in this unfortunate situation for almost a decade now. It is not proposed to provide a fully satisfactory or rigorous answer to this question, but based on a number of empirical studies carried out within and outside the Bank some plausible hypotheses and supporting evidence are presented to shed some light. It needs to be emphasized at the outset, that the analysis presented here should not be interpreted as if the Asian countries were above committing mistakes or they did everything right all the time. Alternatively, it would be unfair to characterize that the Latin Americans were never able to put their act together and kept on repeating the same errors of judgement. It is equally plausible that the facts and hypotheses that guided their policy decisions turned out to be quite different in actual implementation of these policies. The actual outcomes examined over an extended period of time tend to mask the complex interplay of forces and interactions that took place during the course of events in the 1970s and 1980s. The analysis therefore abstracts from these complex interactions and presents a relatively simplified picture of the end results.

DOMESTIC POLICY ENVIRONMENT

The differences in economic and market structure do persist between the countries in the three regions and so do levels of institutional development. They may also, in part, explain for the differentiated economic performance. Other variables such as human resource development and skill mix of the labor force which affect the growth in a longer time horizon may also be equally important. The "new" growth theorists have provided evidence that increasing returns or positive externalities from such factors as knowledge and human capital can explain the divergence in growth rates among developing countries. It is also becoming clear that the impact on growth of better economic policies and more education, together is greater than the sum of each separately. A comparison of the human development indicators of the Asian countries in this sample with those of the most severely indebted countries in Latin America, do not bring out any significant difference in this aspect (see Table 4). Eight out of ten Asian countries in the sample are classified as having medium or low human development indices. On the other hand, five highly indebted countries Chile, Costa Rica, Argentina, Venezuela and Mexico fall under high human development class. Of course, the same indicators for Sub-Saharan Africa are quite low.

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[5] Sachs, ibid.

[6] Doral Donovan, "The sources of External Debt Difficulties: Some empirical evidence." IMF Discussion Memorandum 84/15 (1984).

The role of the state in Asian countries where partnership between state and private sector and between labor and capital has been a distinctive feature of their development strategy may also be advanced as "the dominant" factor that impinges on the performance of these countries. Government intervention is essential for development, but what makes the difference in the outcome is whether this intervention is likely to help rather than hinder economic growth. In East Asian countries, these interventions were, by and large, beneficial and conducive and took the form of simple, transparent rules and policies rather than discretionary controls. The complementarity of a sound policy environment and market-friendly interventions is one of the most encouraging lessons of the development experience that has been amply documented in the forthcoming World Development Report. [7] The role of the State cannot, however, be separated from the strategy and the policies they pursue or the response they make to the external shocks or the way the external portfolio is managed. Our hypothesis is that even after taking account of the differences in the structure and institutions, the most dominant factors in explaining Asia's impressive growth performance in the 1970s and 1980s, have been the orientation of the development strategy, mode of adjustment to external shocks, the nature of macroeconomic policies, the efficiency of investment and portfolio management and finally the domestic saving efforts.

(1) Outward Orientation

First, the Asian countries were generally less affected from recession in part due to the outward-oriented policies that they pursued. When the global recovery began in 1982, they were able to take advantage of the rapid expansion of manufactured goods exports, raising export earnings sufficiently rapidly to reduce their debt/export ratios and escape the debt crisis. By outward orientation it is generally meant a combination of two factors: first, that the level of protection, especially for inputs into the production process, was relatively low (resulting in a sustainable level of a real exchange rate favorable to exporters); and second, that there is relatively little variability in the real exchange rates, so that incentives are stable over time.

The evidence regarding the differences in economic performance arising out of outward or inward orientation of the developing economies has recently been presented in a major study of 95 LDCs for the period 1976-85.[8] The study uses an index of outward orientation on the basis of real exchange rate distortion and variability. This measure was found to be highly correlated with per capita GDP growth in this large sample. The most open quantile of countries which included twelve out of sixteen Asian countries had a per capita growth rate of 2.9%; the next quantile which included the remaining four Asian countries, 0.9%; the third quantile, 0.2% and the most closed quantile, 1.3%. These results strongly imply that trade liberalization, devaluation of the real exchange rate, and maintenance of a competitive real exchange rate could dramatically improve growth performance in many poor countries. The study estimates that the gains from shifting to an "Asian level" of outward orientation and real exchange rate stability are increases of 1.5 percentage points per year in Latin America's per capita growth and 2.1 percentage points per year in Africa's. The outward orientation of Asian countries can be clearly discerned by examining trade openness and price distortion measures in Table 5.

Edwards (1990) has used a modified neoclassical growth model to test the same proposition. Using cross section data from 30 countries, he found strong support for the hypotheses that there exists a negative relationship between the degree of restriction on international trade and economic performance in the developing countries. After taking into account the roles of capital accumulation, growth in the labor force and technological gap, countries with higher degrees of trade intervention tend to grow, on average, slower than

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[7] World Development Report, 1991 (forthcoming).

[8] D. Dollar (1990), "Outward-oriented Developing Economies Really Do Grow More Rapidly: Evidence for 95 LDCs, 1976-85." Economic Development and Cultural Change (forthcoming).

countries with lower trade restrictions.[9]

There are a number of reasons why the difference in orientation could affect growth, both in the short and long run. Outward orientation generally results in a more rapid growth of exports. Competition with foreign producers raises efficiency and there may be externalities associated with exporting that cause open economies to grow more rapidly over long periods of time. There is considerable evidence that the process of exporting, combined with easy availability of imported inputs and machinery, accelerates technological advance in developing economies.[10]

Outward orientation also leads to diversification of imports. High level of exports create an equally high level of demand for imports of various capital and intermediate goods. At the same time, higher income levels associated with higher exports induce demand for additional consumer goods imports that were either previously restricted or faced stiff tariff barriers. Under the new liberalized regime, no single import item (for example, oil) constitutes a large share of the total imports. Thus, just as export diversification leads to relatively stable export price index so does import diversification impart some stability to the aggregate import price index.

Outward orientation therefore makes it possible to use external capital for development, without encountering serious problems in servicing the corresponding debt. Inward orientation of production is considered one of the reasons why Latin American and African economies have experienced "debt crises" that have inhibited growth in the 1980s.

(2) Adjustment to External Shocks

Second, the successful countries treated adverse exogenous shocks as permanent and promptly undertook adjustment, thereby avoiding recourse to borrowing in excess of their capacity to repay. By contrast, those that considered these shocks to be temporary aberrations and postponed adjustment - continuing with normal levels of expenditure financed by external borrowing - now face severe payment difficulties as the borrowed resources were used mainly for consumption. Clearly, countries must be prepared to react rapidly and sharply to negative shocks. Furthermore, being less dependent on commodity exports, Asian countries were able to better withstand the decline in commodity prices.

The timeliness with which countries are able to react to these shocks and the strength and adequacy of the adjustment seem to be a moot point. Those countries which take early remedial action are eventually better off than those which indulge in protracted inaction and allow the crisis to drift or get aggravated.

Malaysia recognized the gravity of the international economic environment early on in the 1981-1982 period and took corrective measures to turn around both the fiscal deficit and the current account deficits very significantly. Indonesia, becoming aware of the softening in oil markets, started the process of drastic adjustment in 1983 to help restore the competitiveness of non-oil exports. Korea decided to retrench its ambitious heavy industry expansion program when it realized that the economy was in serious trouble.

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[9] Edwards, S. (1990) "Openness, Outward Orientation, Trade Liberalization and Economic Performance in developing countries." (World Bank PRE Working Paper 191).

[10] Mieko Nishimizu and Sherman Robinson, "Trade Policies and Productivity Change in semi-industrialized countries." Journal of Development Economics, (September - October 1984)

Seiji Naya,[11] a former Chief Economist of ADB has made a quantitative estimate of the balance of payments effects of external shocks and the policy response of 12 Asian developing countries in making adjustment to these shocks. He estimated that the ten net oil importers had adverse effects averaging 17.5 percent of GNP between 1974 and 1982. The more open economies are more vulnerable to open shocks and thus the effects were larger in percentage terms for the more open countries and smaller for larger or relatively closed economies. Indonesia and Malaysia had favorable effects.

The balance of payments effects can arise either due to terms of trade losses which reflect in part the large increases in oil prices and the export volume effects which reflect the impact of the various recessions. In this study, three-fourths to four-fifths of the effects was due to terms of trade losses.

Adjustments are usually analyzed in terms of expenditure reduction, expenditure switching or financing. Naya argues that adjustments to these external shocks can take place through four different mechanisms: (a) increase in export market share (b) import substitution (c) import savings via lower economic growth (d) net external borrowing. He uses this typology to analyze the outcome.

It was found that the newly industrialized economies (NIEs) relied mainly on increased export market penetration and secondarily on import savings and import substitution. The Southeast Asian oil importers increased their export market shares but also relied on recourse to net external finance. The South Asian countries and the Philippines overwhelmingly opted for external borrowing while the South Asian countries took measures to reduce spending initially, but later expanded external borrowing.

The nature of the policy responses has important implications for the problems of external debt, particularly in the Philippines. It may be useful to recount the experience of the Philippines here - one of the two severely indebted countries in Asia.[12]

"The Philippine crisis resulted from both external and internal causes. External conditions created a difficult situation but inappropriate government domestic and macroeconomic policies turned difficulty into crisis. After a decade of rapid growth, the Philippines faced problems of long-term structural adjustment and short-term stabilization. The long-term problem was to shift the economy to a more open outward-looking stance. The old import substitution could no longer be paid for by taxing exports of primary products; the Philippines needed to promote exports of labor-intensive manufactured goods to achieve sustained economic development. This, in turn, required liberalization of foreign trade, including relaxation of trade restrictions and lessening of tariff rates and their dispersion. However, before structural changes could take place, the external environment became worse. The government began relying more and more on capital market borrowings to cover the saving and foreign exchange gaps. Fiscal deficits mounted and the current account deficit rose in the late 1970s. Rather than cutting expenditures and thus sacrificing some growth in order to stabilize the economy, the government in the early 1980s gambled that export growth would pick up. Between 1980 and 1982, the budget deficit in the Philippines rose from 1.3% of GDP to 4.2%; the current account deficit rose from 5.8% to 8%. Expansionary fiscal policies were financed by external borrowing. The Philippine peso appreciated in real terms against the currencies of major trading partners, lessening the competitiveness of exports and increasing the incentives to import. The government increased investment in poorly managed state enterprises. In the meantime, capital flight reached alarming proportions; domestic savings was discouraged by low real interest rates and the overvalued peso.

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[11] S. Naya. "Effects of External Shocks on the Balance of Payments Policy responses and debt problems of Asian Developing Countries." (ADB Economics Office Report No. 22, December 1983).

[12] The following account is reproduced from James et al (1987), Asian Development, (San Francisco, International Center for Economic Growth).

In response to the worsening external and internal deficits, the Philippine government reversed trade liberalization policies and restricted imports rather than abandoning its inappropriate spending and exchange rate policies. Subsequently, with exports falling and access to additional external finance dwindling, the government was forced to seek a rescheduling of its huge external debt in 1983.

The growth rate of the Philippine economy declined steadily after 1978 despite the government's efforts to prop it up. The growth that was attained under the mismanaged macroeconomic policies proved to be short-lived and expensive. Real GNP declined by over 5% in 1986 and 3% in 1985, and per capita income in 1990 was still below the 1980 level."

A contrasting example is that of India during the same period.[13] The oil price increases worsened India's vulnerable external accounts and exacerbated inflation. Although the economy was already in recession, the government decided against borrowing abroad to absorb this new shock. Instead, domestic savings were boosted from 14 percent of GDP in 1965-72 to 19 percent in 1973-78 by raising taxes and interest rates, reducing public spending, and tightening monetary policy. Domestic energy prices were also raised quickly to the new international levels. By 1978, India had a small trade and current account surplus, a comparatively low debt to GDP ratio and large foreign reserves. Despite the second oil price increase, India's growth rate during 1979-84 averaged 5.1 percent a year, compared with 3.6 percent a year in 1950-79. India, however, expanded its borrowing abroad - both commercial and short term- in the later half of the 1980s to finance its growing budgetary deficits.

The nature of the adjustment prices followed by the highly indebted countries in Latin America has been documented elsewhere.[14] In Brazil, the import substitution policy was supplemented with a heavy reliance on foreign borrowing to finance major investment projects. In Mexico, the populist policies that led to spectacular growth in the public sector and in the fiscal deficits lay behind the crisis. In Chile, the opening up of the Chilean economy allowed the private sector to finance huge increases in consumption - especially durables - with borrowing from abroad.

(3) Macroeconomic Policies[15]

Third, the countries in the Asia region, by and large followed relatively cautious macroeconomic policies in the 1970s and 1980s, thereby avoiding inflation. The kind of policies that were pursued by the successful East Asian countries present a sharp contrast to those followed by the Latin American countries. South Asian countries had, until recently, followed prudent macroeconomic policies but their recent policy performance has raised serious questions. The difference in the case of South Asian countries lies more in their inward-oriented regime rather than the set of macroeconomic policies in the later half of the 1970s and early 1980s.

The Chinese case is quite different and mixed. External borrowing has not been a major issue so far. The development performance has been impressive, but the unfinished reform agenda is long. Over the last decade, China's GDP growth has averaged 9.5 percent per annum. Investment was high throughout and was matched by a strong savings performance, which contained the need for external borrowing. Industrial modernization increased the competitiveness of China's manufactures in the international market and merchandise exports grew from $18.3 billion in 1980 to $52.5 billion in 1989. China's share of international trade rose from 0.97 percent to 1.7 percent during the same period. The average incomes of the 800 million rural

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[13] World Development Report 1985, Box. 4.2

[14] Edwards, S. "Structural Adjustment Policies in Highly Indebted Countries." (UCLA Working Paper 453, September 1987).

[15] The discussion in the following paragraphs on the macroeconomic policies of East Asian countries draws heavily upon F. Larrain and R. Vergara (1991), "Investment and Macroeconomic Adjustment: The case of Asia." (mimeo, The World Bank).

population more than doubled and absolute poverty receded nationwide.

The most significant issue in China, however, is the alleged conflict between reform and macroeconomic stability. The decentralization of decision making and reliance on market mechanisms for price formation and allocation of resources are believed to thwart the attempts to eliminate the macroeconomic disequilibria that generate inflationary pressures. Balassa (1982)[16] has argued, however, that readjustment and reform are not necessarily in conflict and may even complement each other. It has been postulated that important complementarities exist between reform and macroeconomic stability. On the one hand, macroeconomic stabilization and improvement of structural balance would greatly facilitate the smooth implementation of reform; on the other hand, the increases in efficiency to be expected from reform could ease some of the difficult medium-term trade-offs and choices. China's debt burden is relatively low at present and the cautious attitude towards external borrowing showed in the last few years augers well.

(a) *Price Stability*

In East Asia, low inflation and financial prudence have been the policy objectives that were given priority over other objectives in the belief that higher rates of inflation were associated with weaker economic performance. That there was some validity in this proposition can be gauged from Table 6 which shows that low inflation countries in Asia had high domestic saving rates, high investment rate and rapid growth in output while the reverse was true in the case of high-inflation countries.

Even in Indonesia which witnessed high and increasing rates of inflation in the first half of the 1960s the new government made a strong commitment to price and lower rate of inflation compared to resource transfers through the inflation tax. Whether this objective conflicts with employment objectives is not obvious. In the case of Malaysia, M. Ariff (1983)[17] has investigated the possibility of trade off between inflation and unemployment and finds weak support for a traditional, negatively sloped Phillips curve. He therefore concludes that the existence of the trade-off between inflation and unemployment is not borne out by the empirical evidence. For other countries, the evidence is mixed and ambiguous.

The variability of inflation is also greater in countries with high inflation rates. Most countries in Asia recorded low variability except the Philippines where both the variability and the average inflation rate have been high during the 1980-90 period.

Malaysia, Thailand, China, Pakistan, India, Korea and Indonesia recorded average annual inflation rates in single digits during the period and also showed low variability. Bangladesh and Sri Lanka had inflation rates exceeding 10 percent with low and moderate variability respectively. In contrast GDP output deflator in Brazil recorded an annual average increase of 165 percent, Argentina 298 percent and Mexico 68 percent during the 1980-87 period. The variability was also quite high in these countries.

(b) *Monetary and Credit Policies*

There exists persuasive evidence to support the proposition that positive real rate of interest encourages allocation of resources to their best and highest return use under a comparative financial market structure. In the absence of positive real rates, credit has to be rationed by factors other than price. Under these conditions it has been suggested that somewhere between one third and two-thirds of total investment will be wasted, in

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[16] Balassa B. "Economic reform in China," Banca Nazionale del Lavoro, September 1982.

[17] Ariff, M. (1983), "Inflation in Malaysia - an empirical enquiry," in Proceeding to a Conference on Inflation in East Asian Countries, Chung-Ha Institute for Economic Research, Taipei.

the sense of yielding less than its potential.[18] In the East Asian countries, real interest rates were positive and moderately high in the 1980s. (See Table 7)

Thus, although investment was not strictly allocated by the market in many instances, private companies using the funds had to pay positive real rates. Credit was not flagrantly subsidized, but it was directed. To some extent, demand for credit had been limited by price, but still credit availability increased significantly, e.g. from 10.7% of GDP in 1965 to 56.1% in 1987 in Korea, from 14% to 46% in Thailand and from 13% to 62% in Malaysia. In Indonesia, domestic credit grew at an average 21% per year between 1973-81, but the inflation trend was much subdued.

The growth of the formal financial sector in these economies is reflected in the extent of "financial deepening" defined as the growth in the share of financial assets in the economy. The ratio of M2 to GDP (a measure of financial deepening) has risen in all these countries. In Korea it has gone from 11.7% in 1962-65 to 39% in 1985-88; in Thailand from 23.9% to 62.9% and in Malaysia from 27.3% to almost 70% over the same period and in Indonesia from 12.9% to 35% in 1989.

Indeed, maintaining moderately high real interest rates appears to be closely associated with economic performance and financial deepening at the international level. Empirical evidence indicates that countries that have maintained relatively high real interest rates have performed better by a considerable margin than those who have favored negative real interest rates.[19]

(c) *Fiscal Policy*

Expansionary fiscal policies have been the bane of the debt problem in many developing countries. Ninety percent of long term debt of developing countries has either been directly contracted by the Government or guaranteed by it. Therefore, the Government's debt servicing capacity and thus its fiscal position assumes a critical role. The ratio of Government debt to GNP will fall if the non-interest government surplus, as a percent of the debt, exceeds the difference between the interest rate and the growth rate of real GNP.[20] Since many of the highly indebted countries were unable to meet this condition, they had difficulties in making their debt service obligations. On the other hand, NIEs and Asian countries have had, in general, very responsible fiscal policies (except the Philippines). Public savings have been positive every single year since 1970, and the budget deficit, which includes public investment as an outlay, has never reached worrisome proportions. A moderate fiscal expansion has been used only for very short periods of time, to produce a reactivation when internal and external conditions were not favorable. Moreover, when budget deficits have increased, governments have shown a remarkable ability to bring them down quickly, so that they do not jeopardize macroeconomic stability.

In Thailand, fiscal deficits have been around 4% of GDP for several years during the 1980s. The Bank of Thailand, though, has been careful to avoid monetary financing as much as possible. Malaysia has experienced even higher public deficits but the Government has carefully avoided resorting to monetary financing and deficits have been reduced significantly since 1987. Indonesia has averaged deficits up to 5% of GDP but has contained them to 2% in recent years. The deficits were financed mainly through counterpart funds generated by foreign aid and external project assistance.

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[18] Polak, J. J., Financial Policies and Development (Paris: OECD, 1989).

[19] McKinnon, R. (1989), "Financial Liberalization and Economic Development: A Reassessment of Interest Rate Policies in Asia and Latin America." International Center for Economic Growth, ICS Press, San Francisco.

[20] Blanchard et al, "The Sustainability of Fiscal Policy: New Answers to Old Questions," Economic Studies, Vol. 15 (Paris, OECD).

It needs to be stressed that in countries with relatively high domestic rates of savings, public sector deficits of the magnitude displayed in Thailand and Malaysia leave enough space for the private sector without creating inflationary pressures.

(d) *Exchange Rate Policy*

Overvalued exchange rates have been a common occurrence in a majority of Latin American and African countries resulting in losses in production and external competitiveness. The cornerstone of the exchange rate policy in Korea, Thailand, Malaysia and Indonesia, on the other hand, has been to maintain external competitiveness.

Since 1980, Korea has followed a system of gradual adjustments to the nominal exchange rate. determined with respect to a basket of countries. After periods of real appreciation or external difficulties, a one shot devaluation has been used to restore competitiveness of exports. In Thailand, the exchange rate has been pegged to the dollar for three decades, with two devaluations: 10% in 1981 and 14% in 1984. There was also a period of floating rates between 1979 and 1981. In general, low inflation has allowed the preservation of a relatively high real exchange rate, and after periods of mild appreciation, devaluations have been used to restore competitiveness.

Real exchange rate depreciation in Indonesia in 1983 (28%) and 1986 (31%), and the flexibilityachieved through an actively managed float subsequently have played a key role in boosting non-oil exports and reducing the current account deficit.

Malaysia has kept a stable and convertible currency. The real exchange rate has remained very stable over the last two decades. Only in recent years has the currency appreciated by a significant amount. Large inflows of foreign investment, which have pushed up international reserves, are mostly responsible for this appreciation of the ringitt.

(e) *Industrial and Trade Policies*

The thrust of the trade and industrial policies in the ASEAN-4 and NIEs has centered around enhancement of domestic competition and promotion of exportables through the maintenance of realistic exchange rates, enhancement of import competition through lower tariffs and the reduction of non-tariff barriers, removing market-distorting restrictions like price controls and easing various kinds of regulations. As a result, manufacturing value added, on average, grew more than four times as fast in the NIEs and ASEAN-4 (over 10 percent) as in Latin America, and more than three times as fast as in Africa between 1973 and 1988. Manufactured exports led the high growth of the industrial sectors in these countries.

In general, industrial policies in NIEs and ASEAN-4 have placed greater reliance on the private sector as the major source of new fixed investment. The role of the government has been gradually reduced through privatization of existing state enterprises. Many kinds of investment incentives have been used in this attempt.

Korea has widely used import restrictions, particular[illegible]ring the industrialization stage of the 1970s. Although tariffs have not been high,[21] quantitative trade rest[illegible]tions have implied a high degree of protection for some domestic industries. The idea has been to nurture some infant industries, so that they can eventually grow up and become competitive in world markets. This strategy, which worked so badly in Latin America, has

[21] For example, the simple average tariff rate for 1982-83 was 23.5% (James et al. 1987, p 37, ibid.)

produced positive results in specific industries such as automobile and steel.[22] Mistake , however, have also been made, which the authorities have recognized and amended when they abandoned the Big Push strategy. Export subsidies have been used, mainly during period of real appreciation such as in the late 1970s.

In terms of industrial policy, the five year macroeconomic plans targeted certain industries which have been helped through easy credit, tax incentives, subsidies, etc. Efficiency, however, has been encouraged and many of these industries now export their own production successfully to the rest of the world. The experience of Hyundai in automobiles has been a case in point, although lately it has run into some difficulties in the U.S. market.

Thailand followed an import substitution strategy until 1976, with high tariffs and other import restrictions so as to promote domestic industries. However, through the Investment Promotion Act it exempted taxes on imported capital machinery. This encouraged investment and the use of modern technologies. The strategy shifted towards export promotion first in 1972 and then more strongly in 1976, and tariffs were reduced substantially. Some non-tariff barriers are still significant, however.

Malaysia has kept an open trade regime with very few non-tariff restrictions and a low average tariff rate (9.5 percent) though with a relatively high dispersion. According to some authors, this low protectionism is related to the belief of the authorities that the beneficiaries of protectionism would be Chinese-run business.[23] Malaysia has made the most significant progress in privatization with some of the country's best known state enterprises being listed on the local stock exchange. Plans have been drawn to further reduce government ownership of enterprises.

Industrial policies in Malaysia have been an essential ingredient of the modernization plans of the country since its independence. Fiscal and other broad incentives to industrial investment have been provided throughout. As a result, the manufacturing sector has led growth in Malaysia during the last two decades, going from 8.5% of GDP in 1961 to more than 20% in the 1980s.

The Indonesian Government initiated a series of trade reforms by reducing nominal tariffs in 1985 and trade deregulation measures in 1985 by reducing the burden of import licensing. The proportion of domestic production protected by import licensing restrictions was reduced from 41% to 29% and the value of imports subject to controls declined to 21% from 43%.

The bias against foreign investment was curtailed and the role of the local content program was reduced. In 1989 the Government converted the Investment Priority list to a short negative list and removed virtually all regulatory constraints. Private firms have been allowed to establish export processing zones in authorized industrial estates.

(f) *Policy Stability and Credibility*

The role of uncertainty in investment has been emphasized by several authors and is generally associated with the irreversibility of investment. The basic argument goes as follows: if macroeconomic conditions are uncertain, and given that once investment is in place it is impossible to undo it, it may pay to wait. The greater the uncertainty and macroeconomic instability, the lower the investment.

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[22] Collins and Park (1989), "External Debt and Macroeconomic Performance in South Korea," in *Developing Country Debt and Economic Performance*, edited by Jeffrey D. Sachs and Susan M. Collins

[23] See James et al, (1987), ibid.

Korea, Indonesia, Thailand, and Malaysia are examples of economies characterized [illegible] a high degree of stability. There have been no major policy changes in these East Asian countries since the mid 1960. Perhaps the most important was Thailand's switch to an export-led growth strategy in the mid-1970s. Korea's "Big Push" phase was an intensification of some policies started in the 1960s but did not last long, [illegible] and Malaysia's liberalization process of the late 1980s is the reorientation of a system that was becoming increasingly interventionist. These are minor (and relatively few) changes when compared with those in other regions of the world. Latin American countries, for instance, have suffered wide policy changes over the last 30 years. In addition to structural adjustments, stabilization programs have been the norm in Latin America throughout the 1980s, with their sequel of economic recession and relative price volatility. Many countries have undergone several stabilization efforts in the short period of a few years, as in Argentina, Brazil and Peru to name the most prominent. Stabilization programs have been few in the successful cases of East Asia, because they have rarely been necessary.

The low variability of the real exchange rate in East Asia can be observed in Table 8. The average coefficient of variation of the real exchange rate for the period 1975-88 in the four East Asian countries is 0.097; the same figure for a sample of 7 Latin American countries is more than twice this, at 0.201. Moreover, the figure for Thailand, the East Asian country with highest coefficient of variation (0.106), is lower than the figure for any of the seven Latin American countries in the table.

Government policies in East Asia have by and large been credible and consistent with emphasis on promoting exports, savings and investment, and on the industrialization of the economy. Investors inside and outside these countries have perceived these goals as permanent and government behavior has validated these expectations. This has produced an extraordinarily good environment for investment, witnessed by very high private investment rates. The absence of major policy changes over the last three decades, as mentioned above, has no doubt enhanced credibility.

(g) *Income Distribution*

It has been argued that one of the reasons that Latin American governments have been so erratic in their macroeconomic policies may be the big income inequality existing in these countries.[24] Income inequality leads to social pressures that governments have attempted to relieve through populist policies. After one or two years of economic expansion inflation soars, real wages fall, unemployment starts to increase and output declines. The policies prove to be unsustainable and the government has to switch to another set of policies. The populist cycle has been suffered by many countries in the region, some of these more than once.

In East Asia the situation is just the opposite. Indeed, macroeconomic stability is facilitated by equitable income distribution. The income distribution figures for a group of East Asian and Latin American countries (the share in national income of the top and the bottom quantiles of the income distribution), show the ratio of top to bottom income is much lower for East Asian countries than for Latin American ones. In East Asia, the richest 20 percent of the population has, on average, 7.3 times the income of the poorest 20 percent. In Latin America, the ratio is 18.6 times (see Table 9). Moreover, with the exception of Malaysia, the distribution of income in East Asia is within the range shown by developed economies. Furthermore, even in Malaysia the progress has been impressive. The incidence of poverty in Malaysia has declined by 34.4 percentage points between 1973 and 1987. The income differential between the Chinese and Malays has been greatly reduced. In 1973, a Chinese had a 26 percent less chance of being poorer than a Malay, holding other variables constant. By 1987, the differential had been reduced to 7 percent.

[24] Larrain and Vergara, ibid.

Recent work has suggested that income inequality provokes a negative effect on economic growth.[25] It has been postulated that a key channel for this relationship is investment. More equitable income distribution leads to less social conflict, which reduces uncertainty and creates a more stable economic environment for investment.

(4) Capital Flows and Portfolio Management

Fourth, the Asian countries made productive use of borrowed external funds, eased infrastructure bottlenecks, invested in human resources, expanded productive base, and did not allow public sector enterprises to run massive deficits. They ensured that the growth of exports and income exceed the growth of debt and the interest rate. It is only when the interest rate exceeds the growth rate of both GDP and exports, debt and debt ratios grow on an explosive and unsustainable path. The external capital flows were not very large in relation to debt servicing capacity and were diversified over time, with foreign direct investment becoming a growing vehicle for raising external finance. The volume, terms and conditions of borrowing from private and commercial sources were also carefully worked out to avoid a mismatch between benefits stream and the repayment of debt.

The success of their external borrowing strategy can be gauged from the fact that four Asian economies have begun to make large net resource transfers abroad. These transfers are different from those made by the highly indebted countries as they were made in the context of high GDP per capita growth, high investment and current account surpluses. Korea has maintained its investment at 30 percent of GDP but also made net resource transfers of 8 percent of GDP.

One way of measuring the efficiency of capital invested is examining the incremental capital output ratios. Table 10 presents ICORs for five East Asian countries and reveals that these countries have been quite efficient in terms of their investment. ICORs in these economies are within the range shown by the most efficient countries. The sharp and short-lived increase in Malaysia's figures during the mid-1980s is associated with the 1985-86 recession; ICORs of subsequent years show a marked improvement. This outcome is closely linked to the trade and industry policy stances of these countries which have been discussed earlier.

Recent empirical work on the sources of growth of income carried out by the Bank provides further corroborative evidence for efficiency of resource use, going beyond capital alone.[26] Table 11 decomposes the source of GDP growth by the relative contributions of capital, labor and total factor productivity (TFP). TFP captures the efficiency with which inputs are used. For the period 1960 -73, the differences in the relative contributions of capital and labor for East Asia and Latin America do not appear very large but for the subsequent period 1973-87, TFP accounted for one-fifth of the growth in East Asia while its contribution in both Africa and Latin America was strongly negative. This study also found a strong and positive association between productivity growth and aggregate growth. The decline in Latin America GDP growth in 1973-87 relative to the earlier period is closely matched with the decline in TFP.

Asian countries not only invested the borrowed resources productively but had a balanced portfolio of foreign capital flows. ASEAN-4 and China relied heavily on Foreign Direct Investment flows in addition to borrowing from commercial sources, bilateral and multilateral institutions at competitive rates. ASEAN-4 and China made sensible decisions in relation to external borrowing about (a) the terms of foreign borrowing - interest, maturity and cash flow profiles (b) the currencies in which liabilities are determined (c) the balance between fixed rate and floating rate instruments; (d) ways of sharing risk between lenders and borrowers, including the balance between debt and equity and (e) the level and composition of a country's reserves. The

[25] Alesina and Rodrik (1991), "Distributive Politics and Economic Growth," NBER working paper # 3668

[26] The World Bank, World Development Report, 1991 (Washington, D.C.)

maturity structure, interest rate and currency composition were compatible with the repayment capacity of the projects or investments for which the funds were borrowed. The level and composition of the reserves were both adequate. Of course, there were exceptions to these generalizations in individual country cases at certain points of time. Indonesia's growing exposure in yen was a source of concern in 1987 and 1988 while the size of Korea's debt stock in 1982 had created some questions in the minds of the creditors.

South Asian countries received substantially large proportions of capital flows in the form of concessional assistance. It is only in the late 1980s that India became a significant borrower in the international capital markets. Finally, the share of variable interest rates in total debt was comparatively lower than the Latin American countries and thus the rise in interest rates did not result in immediate servicing difficulties.

FDI has contributed to growth both by augmenting resources available for capital formation and by improving the efficiency of investment. The rate of approval of FDI in ASEAN countries during the period 1986-89 is impressive. According to some estimates, the total approvals escalated to $16.7 billion in 1989 compared to $2.5 billion in 1986. FDI flows account for more than 50% of all types of capital flows to these countries. In China, the pledged value of foreign direct investment amounted to $34 billion at the end of 1989, of which $15.4 billion had actually been disbursed. Disbursements have risen to $3.3 billion annually and foreign investors have made a major contribution to the development of services, oil exploration and export-oriented manufacturing industries. As a result, these countries do not face difficulty in attracting foreign savings at relatively lower cost.

(5) Domestic Savings

Finally the domestic savings rates and domestic resource mobilization efforts in these countries were intense which enabled them to finance a large proportion of their overall investment without resorting to excessive external borrowing.

For the period 1973-80, Asia's domestic savings rate was 25.3% while investment ratio was 26.1%. In the subsequent period 1980-87 these ratios were 26.7% and 28.1% respectively. Foreign resources inflows were thus modest despite the two oil shocks and other adverse external circumstances. Empirical studies have also shown a stronger correlation between growth rates in GDP and domestic savings ratios than between growth rates and investment rates. Thus the policy relevance of stronger domestic saving effort becomes more pronounced.

When domestic savings decline in relation to national income while external indebtedness increases, the substitution of external borrowing for domestic savings implies a rise of funds borrowed from abroad to finance consumption. The evidence for Asia shows that this has not happened.

The saving rates of China and Malaysia exceeded 35% while those of Indonesia, Malaysia, Thailand, and Korea are about 30%. India saves about 21% of its income. In Thailand, significant increases in government savings have taken place. The Philippines, Pakistan and Sri Lanka have lower domestic savings rates in the range of 10 to 15 percent while Bangladesh has barely positive rates. The savings GDP ratio in Latin America was 20% and Sub-Saharan Africa about 13%.

Fry[27] has analyzed determinants of savings ratios in Asian developing economies and found that these ratios are increased by income growth. National savings ratios are also raised by a higher overall government budget balance and by higher real deposit rates of interest. On the other hand, higher population dependency

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[27] Fry, M.J., "Domestic Resource Mobilization in Developing Asia: Four Policy Issues." Asian Development Review 1991, Vol. 9, No.1.

ratios, expansionary monetary policy and higher foreign debt reduce savings. As pointed out earlier, East Asian countries had higher real rates of interest, relatively lower budgetary deficits and tight monetary policies throughout this period with some exceptions and interruptions.

In recent years, however, the growing government budgetary deficits in India and Pakistan have created pressures on the sustainability of their creditworthiness. Interest payments on internal and external borrowing are growing rapidly and accounted for 30% of current expenditure in Pakistan and 25% in India. The domestic resource gap is bigger than the current account deficit as remittances from workers abroad are substantial. But the recent Gulf Crisis exposed the vulnerability of these countries to reliance on this source of foreign exchange. The heavily indebted countries of Latin America got into trouble precisely because of large public sector deficits which were financed through monetary expansion and large borrowing. The South Asian countries should learn from the lessons of the HICs and take steps to contain their fiscal imbalances. But they must also ensure that fiscal contraction does not reduce investment in social sectors and that demand management is accompanied by structural reforms, particularly in incentive policies.

CONCLUSIONS

The case of Asian developing countries in managing their foreign debt burden presents a contrast to Latin American and African countries.[28] For the latter group, the combination of inward-oriented strategy, poor quality of macroeconomic policies and investment in unproductive ventures contributed a great deal towards the final outcome. A study of the twelve highly indebted countries carried out by the World Bank in the mid-1980s, concluded that the quality of economic management in these countries themselves was the decisive determinant leading them towards the path of debt crisis.

The Asian countries, with a few exceptions, pursued an outward-oriented strategy, and prudent macroeconomic policies. They made quick adjustment to external shocks by expenditure switching, expanding exports and curtailing consumption. Most of the borrowed and locally raised funds were invested in productive uses that raised the capacity of the economy to repay the debt. These countries relied heavily on domestic savings and domestic resources for financing investment.

It would be misleading to suggest that the Asian countries did not have their crisis periods - either induced by domestic policy slippages or external shocks. Korea met a serious crisis in 1980. Indonesia faced difficult problems when oil prices fell in 1983. Malaysia was confronted with a current account deficit of 14 percent of GNP in 1982. But the important point to note is that in each case adequate, strong, and timely policy responses contained the situation. The crises were not allowed to drift or get aggravated. So it is only when a whole period of two decades is examined, the end-results appear impressive as presented in this paper.

In the Latin American countries, the governments expanded external borrowing to offset the effects of external shocks. In Brazil, it led to substitution for domestic savings by foreign resources to support import substitution strategy and in Mexico fiscal deficits were financed by external borrowing.

At the same time, the domestic residents of these countries transferred billions of dollars abroad. Why did capital flight occur on such a massive scale? The answer has much to do with fiscal, monetary and balance of payments management, and in particular with the maintenance of overvalued exchange rates and unattractive interest rates intended to curb inflation. Overvalued exchange rates and uncompetitive interest rates have clearly been shown to encourage capital flight. In the longer run, distorted exchange and interest rates erode

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[28] The references in Latin American and African countries in this study pertain to the period prior to 1987. Since 1987, Chile, Mexico and Venezuela have undertaken successful economic reforms and achieved significant progress. Argentina, Peru and Brazil have also initiated some reforms, but it is too early to judge the results. Similarly, more than twenty African countries are currently pursuing structural adjustment programs and the preliminary results are encouraging

creditworthiness because of their depressing effect on exports and savings.

Again, in countries where funds were borrowed specifically for investment purposes and in fact invested rather than consumed, much of the investment yielded low or negative economic returns. These poor investments, however attractive the terms of borrowing, became a major problem as they failed to generate an income stream to service debt and depressed the efficiency of the economy as a whole.

Countries such as Argentina, Mexico and Venezuela which experienced massive private capital flight while they were stepping up external borrowing courted servicing trouble, since much of the borrowed money was clearly not invested in high return projects. As a result, these countries were faced with debt payment obligations, the income counterpart of which was out of the governments' reach. The return of flight capital has started in Mexico and Venezuela - both of which have embarked on successful economic reforms since 1987.

In the ASEAN-4, China, India and Korea, the investment rates were relatively high, financed mostly out of domestic savings and the foreign borrowing was used judiciously and widely as a complement to domestic savings. Foreign capital did not account for more than 2 to 3 percent of GDP in these countries while the investment rates were on an average 30 percent of GDP.

Particular attention was paid to price stability which reduced the uncertainty and strengthened investor confidence. Tight monetary and fiscal policies along with flexible exchange rate management maintained external competitiveness. Industrial and trade policies induced private investment, promoted manufacturing sector and manufactured exports and reduced price distortions. Policy continuity helped to strengthen credibility and stability while equitable income distribution reinforced credibility by minimizing social and political tensions.

The lessons that can be drawn from this comparative study of highly indebted countries and Asian countries are (a) that success in managing debt is closely related to macroeconomic management as such and (b) that macroeconomic stability and prudent economic policies - both macro and micro- stand out at the top of the pyramid of the factors that influence external debt outcomes of developing countries. If these policies are generally sound, sporadic episodes of overborrowing or inadequate attention to the terms, maturity and currency composition of external debt would tend not to make a large difference. But if the basic policies are inadequate then such acts of indiscretion in external debt management tend to get magnified and create serious difficulties for the debtor countries. The recent upturn in Latin American countries, particularly in Chile, Mexico and Venezuela, which are now pursuing successful macroeconomic adjustment, tends to provide support for the validity of these lessons.

Table 1. Average Annual Growth Rate of Long-Term Debt

	1973-80	1980-87
East Asia	22.7	12.7
South Asia	11.2	13.4
Latin America	21.6	9.1

Sources: World Bank, World Debt Tables,1990.

Table 2. Comparative Debt Indicators 1980-90

	Asia		Latin America	
	1980	1990	1980	1990
Debt/GNP	19	25	35	48
Debt/Exports	108	108	197	261
Debt Service/Exports	15	15	37	33
Interest/Exports	9	7	20	17

Source: World Bank data.

Table 3. Economic Performance Indicators

	1965-73		1973-80		1980-87	
	Asia	LAC	Asia	LAC	Asia	LAC
Growth of GDP	5.3	5.8	5.6	5.0	6.8	1.5
GDP output deflator	1.8	3.5	6.8	15.9	6.1	39.8
Growth of Merchandise Export	7.1	-0.4	8.5	2.2	9.0	3.4
Growth of Investment	7.8	7.1	8.7	5.4	7.9	-4.0
Growth of Per Capita Consumption	2.1	2.9	3.2	2.9	3.8	-0.7
Current Account Balance / GDP	-2.0	-2.6	-6.3	-3.1	-2.0	-2.7
Share of Manufacturing in Exports	29.4	10.9	37.5	17.7	50.2	23.8

Source: World Bank data.

Table 4: Human Development Indicators for Asia and Latin America

		1990 HDI Rank	199C HDI Value
High Human Development	Korea	35	0.884
	Chile	38	0.878
	Costa Rica	40	0.876
	Argentina	43	0.854
	Venezuela	44	0.848
	Mexico	45	0.838
	Malaysia	52	0.802
Medium Human Development	Panama	54	0.796
	Jamaica	59	0.761
	Brazil	60	0.761
	Colombia	61	0.757
	Thailand	66	0.713
	Sri Lanka	75	0.665
	Ecuador	77	0.655
	Peru	78	0.644
	China	82	0.614
	Philippines	84	0.613
	Nicaragua	85	0.612
	Guyana	89	0.589
Low Human Development	Indonesia	98	0.499
	Honduras	100	0.492
	Bolivia	110	0.416
	Pakistan	120	0.311
	India	123	0.308
	Bangladesh	136	0.186

Source: UNDP, Human Development Report 1991. (New York, Oxford University Press, 1991)

Table 5: Trade Regime and Price Distortion Ranking Measures

	Trade Openness Measure, 1988 (most open to least open)	Price Distortion Measure, 1990 (least distorted to most distorted)
Singapore	1	12
Hong Kong	2	2
Malaysia	3	13
Thailand	9	6
Sri Lanka	10	1
Indonesia	11	23
Pakistan	13	7
Philippines	15	15
Bangladesh	19	3
Nepal	na	5
India	na	20
Fiji	na	19

Source: Leamer, Edward (1988), "Measures of Openness" in Robert Baldwin, ed. Trade Policy Issues and Empirical Analysis, Chicago: University of Chicago Press, and Dollar, David, "Outward-Oriented Developing Economies Really do Grow more Rapidly: Evidence from 95 LDCs 1976-85." mimeo.

Table 6: Domestic Saving, Investment and GDP: 1980-90
Average Annual Percentages

	Low Inflation Countries[a]	Moderate Inflation Countries[b]	High Inflation Countries[c]
Domestic Saving Rate	33.0	21.8	5.7
Investment Rate	30.8	25.5	18.4
GDP Growth Rate	7.2	5.1	2.7

Notes: a = Average annual inflation rate of 6 percent or less;
b = Average annual inflation rate between 6 and 10 percent;
c = Average annual inflation rate greater than 10 percent.

Source: ADB, Asian Development Outlook 1991.

Table 7: Real Interest Rate (in %)

	1970-80	1981-88
Bangladesh	-5.7	0.1
India	-0.9	1.1
Pakistan	-3.3	1.7
Sri Lanka	0.6	7.8
Thailand	-0.8	7.4
Malaysia	1.3	5.0
Indonesia	-0.1	6.4
Philippines	-3.0	-1.5
China	3.3	0.3
Korea	0.2	5.3
Average of the above	-0.8	3.4
Average of the HICs	-2.9	-89.9

Note: HICs are 17 highly indebted countries as defined in the World Debt Tables 1988-89.

Source: World Bank data.

Table 8: Volatility of the Real Exchange Rate: 1975-1988

	Coefficient of Variation
East Asia	
Korea	0.095
Singapore	0.091
Thailand	0.106
Malaysia	0.094
Average	0.097
Latin America	
Argentina	0.247
Brazil	0.114
Chile	0.274
Colombia	0.230
Mexico	0.210
Peru	0.154
Uruguay	0.181
Average	0.201

Source: World Bank data.

Table 9. Income Distribution: an International Comparison

	Percent of National Income bottom 20% (1)	top 20% (2)	ratio (2)/(1)	Per-Capita Income (US$) (3)
Asia				
Hong Kong	5.4	47.0	8.70	9220
Indonesia	8.8	41.3	4.69	440
Korea	5.7	45.3	7.95	3600
Malaysia	4.6	51.2	11.13	1940
Singapore	5.1	48.9	9.59	9070
Taiwan	8.8	37.2	4.23	2530
Thailand	5.6	49.8	8.89	1000
Average	6.3	45.8	7.27	3971
Latin America				
Argentina	4.4	50.3	11.43	2520
Brazil	2.4	62.6	26.08	2160
Chile	4.2	60.4	14.28	1510
Mexico	2.9	57.7	19.90	1760
Peru	1.9	61.0	32.11	1285
Venezuela	3.0	54.0	18.00	3250
Average	3.1	57.7	18.61	2080
Industrialized Countries				
France	6.3	40.8	6.48	16090
England	5.8	39.5	6.81	12810
Italy	6.8	41.0	6.03	13330
Japan	8.7	37.5	4.31	21020
United States	4.7	41.9	8.91	19840
West Germany	6.8	38.7	5.69	18480
Average	6.5	39.9	6.14	16928

Sources: World Bank, World Development Report (1989, 1990), Washington, D.C., and country-specific sources. For Chile, Instituto Nacional de Estadisticas, September 1989.

Table 10 Incremental Capital Output Ratio

Year	Korea	Thailand	Malaysia	China	Indonesia
1971	1.47	2.25	1.78	1.97	0.96
1972	1.83	2.39	1.48	2.44	1.12
1973	1.23	1.61	1.37	1.92	1.05
1974	1.63	2.21	1.85	3.42	1.23
1975	1.80	2.04	3.14	2.01	1.59
1976	1.42	1.56	1.39	16.12	1.39
1977	1.86	1.78	1.82	2.05	1.31
1978	2.18	1.69	1.93	1.90	1.50
1979	2.65	2.23	1.69	2.63	1.72
1980	7.77	2.26	2.33	2.52	1.45
1981	2.03	2.06	2.65	2.54	2.54
1982	2.39	2.24	2.89	2.08	4.86
1983	1.84	1.88	2.80	1.96	2.11
1984	2.07	2.00	2.49	1.79	2.28
1985	2.33	2.39	5.21	2.22	3.52
1986	1.72	2.00	3.10	2.84	2.73
1987	1.85	1.61	1.96	2.53	2.77
1988	1.92	1.50	1.68	2.56	2.34
1971-88	2.22	1.98	2.31	3.08	2.03
1971-75	1.59	2.10	1.92	2.35	1.19
1976-80	3.18	1.90	1.83	5.05	1.47
1981-88	2.02	1.96	2.85	2.32	2.89

Notes: (1) ICOR = Investment(t) / [GDP(t) - (1-d)GDP(t-1)];
(2) d = depreciation = 0.07.

Source: World Bank data.

Table 11: Sources of Growth
(Percentage share of output growth accounted for by factor growth and total factor productivity)

	1960-1973			1973-1987			1960-1987		
	Capital	Labor	TFP*	Capital	Labor	TFP	Capital	Labor	TFP
Africa	59	22	17	92	37	-27	73	28	0
East Asia	50	16	35	62	17	20	57	16	28
South Asia	81	20	0	55	19	24	67	20	14
Latin America	55	20	25	94	51	-47	67	30	0

Source: World Bank Development Report 1991 (Table 2.3)
* TFP: Total Factor Productivity

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