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Debt, Policy, and Performance: An Introduction

Susan M. Collins

For the developing countries, the 1970s were a time of growing external indebtedness but strong real growth. Borrowing seemed to be part of a sensible strategy of growth and development. In the 1980s, however, the role of foreign borrowing was much less innocuous. After 1982 the majority of heavily indebted countries found themselves in the midst of a debt crisis which was more severe and more persistent than most observers had predicted. Growth rates were stagnant and often negative. In many cases, per capita incomes in 1987 were below their 1980 levels. Fixed capital formation as a share of income declined precipitously, diminishing prospects for future growth. More troubling, the indicators of debt burden rose in a large number of countries. The debt crisis remains a long way from resolution.

At the same time, there have been substantial differences in the experiences of the heavily indebted countries. Some countries announced debt moratoria while others avoided a crisis and countinued to repay their debts on, or ahead of, schedule. Some maintained relatively high growth rates and financial stability during the early and mid-1980s, while others wrestled with exploding inflation.

These diverse experiences raise interesting and important questions about the roles of foreign borrowing and macroeconomic policy for small, open economies in an uncertain world environment. How did those countries which navigated the series of external shocks more successfully differ from those which are still struggling to "adjust"? Did they simply borrow more prudently? How are the differences in performance attributable to the

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severity of external shocks as opposed to current and previous policy actions? How did external debt interact with political, social, and economic structure?

The NBER country studies (volumes 2 and 3) examine in detail the policy and performance of eight heavily indebted developing countries: Argentina, Bolivia, Brazil, Korea, Indonesia, Mexico, the Philippines, and Turkey. The countries differ in many ways. Indonesia and Bolivia are low-income countries while the rest are middle income. Mexico and Indonesia are oil exporters, Bolivia exports natural gas and some oil, while the other countries are oil importers. Korea, Indonesia, and Turkey had relatively strong macroeconomic performance in the early to mid-1980s, although foreign borrowing played a central role in their development. Brazil did relatively well during 1982–84, but emerged as a "problem debtor" by 1986. In Argentina, Bolivia, Brazil, and Mexico, price instability interacted with external debt to exacerbate the difficulties of stabilization and structural adjustment. In those countries and in the Philippines, improved external balance came at the expense of domestic investment and growth prospects. Thus, the allocation of domestic resources among investment, consumption, and net transfers abroad to service the debt remains a critical issue.

Each study takes a broad perspective, examining the role of debt within the context of macroeconomic policy and performance. While there is no single model or approach, there are common elements throughout. In particular, the focus is on the debtor country's perspective. Also, each study contains extensive data tables in the text and appendices. Finally, the authors have attempted to integrate social and political factors into their analyses and to emphasize the importance of historical context.

The most striking aspect of these country studies is the similarities in their conclusions. It appears that countries which performed well in the 1980s differed from the other countries in three fundamental ways. First, they maintained stable and competitive real exchange rates. Second, they were successful in having a disciplined fiscal policy, containing budget deficits and maintaining a broad tax base. Third, they emphasized investment with incentives for capital accumulation in export sectors. While microeconomic policies, the trade regime, and the severity of external shocks all played a role (especially in the Philippines), these three macroeconomic policies stand out in explaining the range of performances.

The next section provides a brief overview of the experience of each country. The third section turns to a cross-country comparison of the role of foreign borrowing and macroeconomic policy in the diverse performances.

External Debt and Macroeconomic Performance

Three of the countries, Indonesia, Korea, and Turkey, maintained moderate to high real growth in the early to mid-1980s, with foreign borrowing playing a central role in each experience. In Indonesia, balance of payments difficulties erupted in 1966. They resulted in a debt rescheduling and a coordinated, long-term plan of official assistance. Turkey's external crisis came in 1977, after the first oil price shock but well before repayment difficulties emerged in the other heavily indebted countries. Finally, Korea's economic crisis began in late 1979 as a result of external shocks and internal political and economic factors. The crisis was relatively short, as performance had improved considerably by 1981. While Korea did not reschedule its debts, it did undertake a substantial shift in economic policies.

The Philippines presents a stark contrast. Economic performance deteriorated sharply during the 1980s, and the economy remains far from a path of stable growth. In many respects, the Philippine experience was similar to Mexico's. Both borrowed to finance capital flight and public investments which did not pay off in long-term growth or foreign exchange earnings. However, Mexico exports oil while the Philippines is an oil importer.

In Argentina and Brazil the main economic problems revealed themselves in the form of inflation rather than as pressure on the external balance. However, debt played a central role both in fueling the inflation and in compounding the difficulties of debt reduction.

South Korea

South Korea is widely heralded as an economic success story. In 1987 real growth was 12 percent, inflation was just 3 percent, and the trade surplus had risen to nearly 9 percent of GNP. However, as Collins and Park emphasize, Korea was not always a high growth surplus country. On the contrary, it faced a severe crisis in 1980. Real output declined by 5 percent, inflation rose to nearly 30 percent, and the trade deficit mushroomed to 9 percent of GNP. Korea borrowed heavily to finance these deficits and by 1981 was the fourth largest debtor country in the world, behind Argentina, Brazil, and Mexico. How then was Korea able to combine external adjustment with real growth and price stability?

A poor, war-devastated economy heavily dependent on foreign aid in the 1950s, Korea embarked on a new economic strategy of active export promotion and emerged as a newly industrialized country with growth rates averaging over 9 percent per year in the mid-1960s and 1970s. High rates of investment in exportables and competitive exchange rates, with credible and consistent incentives to exporters, are the key factors behind Korea's growth. Fiscal policy was used countercyclically, but budget deficits were not allowed to become large. Initially, domestic saving rates were very low, and high rates of investment were financed by extensive foreign borrowing. A remarkable aspect of Korea's development has been a trend rise in aggregate domestic savings from less than 6 percent of GNP in the early 1960s to over 30 percent by the mid-1980s.

Korea's economic strategy shifted during the early 1970s. Concerned about industrial deepening and building up military strength, policymakers launched the Big Push to develop heavy and chemical industries in 1973.

Investment was to be increased and concentrated in these sectors. However, the period coincided with the first oil price shock and slowdown in world growth. Korea decided to pursue the Big Push nonetheless and borrowed heavily to finance the investments. While fiscal policy was expanded to stimulate growth, the exchange rate was devalued and then fixed, and heavy taxes were imposed on petroleum products. World demand recovered during 1976–78, improving Korean export performance, and high growth rates resumed. Savings rose and the current account deficit was eliminated.

However, a growing number of economic dislocations became apparent. The real exchange rate began to appreciate, export growth slowed, the current account deteriorated, and inflation surged. The government began to intervene more heavily in domestic markets, controlling prices, restricting imports, and rationing credit. As the other country studies make clear, this is the same pattern that emerged in countries which ran into difficulty. Korea differs in that these distortions were addressed before they became extreme. Policymakers became increasingly concerned about inflation and economic distortions. A new stabilization plan, announced in 1979, called for monetary and fiscal restraint, gradual reductions in price controls, and trade and credit market liberalizations. This policy shift was initiated before domestic authorities were forced to adjust since the oil shock had not yet hit, and foreign lending was still available.

Interestingly, the initial program did not call for devaluation despite the fixed exchange rate and resulting appreciation. The exchange rate adjustment came in January 1980 in the midst of the crisis. Still, Korea's overvaluation was corrected after the real exchange rate had appreciated by 25 percent. In contrast, Argentina experienced a real appreciation of over 80 percent between 1977 and 1980, before an adjustment was undertaken.

Despite the severe shocks which hit Korea in 1979 and 1980, a full-scale debt crisis was avoided. However, the assassination of President Park, disastrous agricultural harvests, the rise in oil and commodity prices, higher interest rates, and the slowdown in world demand all contributed to very poor economic performance in 1980.

Collins and Park point to four key elements which explain the impressive economic turnaround between 1980 and 1985. First, Korea was given breathing space by foreign creditors for the stabilization and structural adjustment. The devaluation did not generate an immediate export recovery. But fiscal policy was expansionary in 1980–81 to stimulate growth. Imports were contained, not through recession but because of the recovery in agricultural output which reduced food imports and boosted growth. Korea continued to borrow in the early 1980s to finance the (shrinking) current account deficits. The economy did not undertake a structural readjustment at the same time that austerity measures were used to improve external balance. Only in 1982, as output and export growth improved, did a fiscal contraction take place.

Second, Korean policy was stable and consistent. The real exchange rate varied less than in most developing countries. Also, budget deficits were kept relatively small, averaging 2.7 percent of GNP during 1973–86 and ranging from 1.0 percent to 4.7 percent.

Third, Korea persistently maintained high rates of investment throughout the adjustment (29 to 33 percent of GNP). These investments placed Korea in a prime position to take advantage of the revival in world demand.

The final element is the dramatic rise in domestic savings. While Collins and Park show that a large part of the increase is associated with Korea's rapid growth, much of Korean saving behavior remains unexplained.

Turkey

Turkey is unusual in that it experienced a debt crisis in 1977, *before* the second oil shock which caused most of the other indebted countries to have repayment difficulties. At the time, it was the most severe debt crisis of the postwar period. Turkey rescheduled its debts and undertook a comprehensive stabilization and liberalization program. By 1982, as the debt crisis was just erupting in most countries, Turkey had reestablished creditworthiness. In explaining the timing of events, Celâsun and Rodrik argue that it was not the 1973 oil shock and the policy response that differentiate Turkey. Instead, their analysis highlights the role of convertible Turkish lira deposits (CTLDs), a scheme for mobilizing short-term foreign loans.

The Turkish episode had four phases. In 1963 Turkey launched the first in a series of five-year development plans. The plan embodied an import substitution strategy with emphasis on domestic, especially public sector, savings. The plans were successful in achieving moderate growth and in containing inflation. However, trade restrictions and increasing overvaluation discouraged exports. By the end of the 1960s, growth began to slow and attempts at reorientation, including devaluation and some trade liberalization, were not followed through.

Turkey's debt crisis erupted at the end of the second phase (1972–77). It began with a surge in worker remittances from abroad in 1972–73, which stimulated growth, generated a current account surplus, and removed the impetus for policy refocus. This reluctance to undertake macroeconomic adjustments distinguishes Turkish policy from policies in Korea and Indonesia in the late 1970s. With its large foreign exchange inflows leading to a debt crisis largely through macroeconomic mismanagement, Turkey's experience parallels on a smaller scale what was to happen later in Mexico.

Turkey embarked on an ambitious industrialization plan, concentrating on capital-intensive industries. As in Korea, the period saw rapid debt accumulation, growing price distortions, budget deficits, and exchange rate appreciation. Exports stagnated, and the current account deteriorated, especially during 1975–77 when public spending surged, financed through domestic credit expansion, financed in turn by foreign borrowing. Celâsun and Rodrik argue that the dynamics of the CTLDs, which encouraged short-term private loans from abroad by protecting domestic borrowers from exchange risk, allowed the surge in spending to take place. The loans were converted to domestic currency, expanding the domestic money supply and providing credit to the public sector. As overvaluation increased, the current account deteriorated, foreign exchange reserves fell, investors lost confidence, and the scheme collapsed.

During 1978–79, Turkey rescheduled some of its debt and initiated a series of stabilization programs. However, fiscal and exchange rate adjustments were too little, too late. The external balance improved through import compression, but investment and growth declined while inflation accelerated. This period of adjustment parallels the experiences of many other debtor countries. The case studies show no examples of programs that achieved stabilization with growth when the trade balance improvement came from import compression.

From 1980 to 1982, Turkey launched a comprehensive stabilization plan. The initial policies were orthodox, export-oriented shock treatments, including devaluation and fiscal retrenchment. Real wages fell sharply, as did private spending, but Turkey managed to combine external adjustment with real growth. The key was surprisingly strong export performance. While real depreciation was important, Celâsun and Rodrik attribute the largest portion to "special factors," including the strong demand in the Middle East associated with the Iran-Iraq war and hefty export subsidies. They also stress the importance of debt relief, together with substantial new lending from the IMF, the World Bank, and the OECD which reduced the need for import compression. These external factors clearly eased the difficult early stages of Turkey's adjustment.

Indonesia

Indonesia's debt crisis occurred in the mid-1960s, not during the 1970s and 1980s. Woo and Nasution emphasize Indonesia's earlier political and economic crisis in explaining why macroeconomic performance was relatively strong in the 1980s. Prudent macroeconomic management, in particular fiscal and exchange rate policies, also explain why foreign exchange inflows from oil revenues did not lead to a debt crisis as they did in Mexico and Turkey.

When General Soeharto took office in October 1965 following a military coup, Indonesia was in the midst of civil war and economic turmoil. There were growing budget deficits, external debt and inflation, overvalued multiple exchange rates, stagnant economic growth, and a shrinking export sector. One of the government's first tasks was to stabilize the economy. A generous long-term plan of official assistance, including direct assistance and favorable terms for rescheduling existing debts, was coordinated by Western governments. This assistance enabled the government to raise investment, take advantage of a strong resource sector, and stimulate growth. In many respects, Indonesia's growth strategy in the late 1960s paralleled Korea's strategy. The government adopted a pro-export orientation and a balanced budget requirement. (Budget deficits could not be financed by domestic credit creation although they could be financed by foreign borrowing.) Woo and Nasution argue that the willingness to use active exchange rate policy to maintain competitiveness, along with incentives for agriculture and light manufacturing, arose from the desire to retain political support in rural areas. In any case, 1966 to 1971 was a period of strong growth in output and exports.

The next phase in Indonesia's macroeconomic history came with the fixed exchange rate during 1971–78. Strong export performance and then growing oil revenues led to a sizable current account surplus. By 1974 Indonesia had regained access to international financial markets. However, the foreign exchange inflows did not trigger aggressive debt accumulation leading to a debt crisis as occurred in Mexico and Turkey. Although the government increased investments and other expenditures and did not cut back on external borrowing as oil revenues rose, debt declined as a share of exports and of GNP. The government's relatively cautious debt strategy was reinforced by the default of the state-owned oil company in 1975, which had borrowed extensively and was unable to roll over its large short-term debts. As a result, state-owned enterprises were denied direct access to international credit markets.

In 1978 Indonesia devalued by 50 percent, marking the return to an active exchange rate management. The striking feature of this devaluation is that it was not triggered by a balance of payments crisis. Economic growth and the external balance were strong. Foreign exchange reserves were abundant. However, the real exchange rate had appreciated, hurting the competitiveness of nonoil exports. Nonoil exports responded strongly to the devaluation. As export receipts grew in 1979–81, public investment was increased further.

Indonesia did run into some difficulties in 1982 and 1983 as oil prices slumped and world demand stagnated. Policymakers turned increasingly to quantitative import restrictions, exacerbating microeconomic distortions. Still, macroeconomic policies were the key to explaining Indonesia's avoidance of a debt crisis. Strong export performance aided by active exchange rate adjustment, prudent debt management with relatively little short-term borrowing, and the favorable terms of their existing debt from the earlier rescheduling were the main elements of Indonesia's success.

The Philippines

Philippine macroeconomic performance stands in stark contrast to the performance in the three other non–Latin American countries in the NBER group, and to expected performance in the late 1970s when the Philippines was often grouped with the Asian tigers. In the 1980s, the Philippines became the only Asian country to declare a debt moratorium. Real growth, which had averaged 4.6 percent during 1980–81, averaged −5.2 percent during 1984–85.

In some respects, macroeconomic policies in the Philippines during the late 1970s were not dramatically different from policies in Korea or Indonesia. The real exchange rate appreciated at times during 1970–82, but by at most 15 percent. Korea's real appreciation of the late 1970s was over 25 percent. Similarly, the Philippine budget deficit rose from 2 percent of GNP in 1978 to 6 percent in 1981. However, Korea's budget deficit rose from 1 percent of GNP in 1979 to 5 percent in 1981. Both the real appreciation and the budget deficits were small when compared to 80 percent real appreciations and 18 percent budget deficits in Argentina.

Why then did Philippine macroeconomic performance deteriorate by so much? Dohner and Intal point to two factors. First, the magnitude of the external shocks was more severe for the Philippines than for most other developing countries. Unlike Korea, for example, the Philippines suffered a secular terms of trade deterioration. Some structural adjustments were required if the country were to maintain growth rates and a sustainable external balance, even without the two oil price shocks. Second, the political-economic environment under President Marcos was of critical importance. Individual favoritism in loan allocation and misallocation of other resources discouraged private investment, particularly in exportables, and encouraged capital flight. Government intervention became considerably more extensive than in Korea or Indonesia during the 1970s, exacerbating the difficulties of an overvalued exchange rate and growing budget deficits.

The Philippine experience had five phases. In the first, from 1966 to 1969, Marcos borrowed heavily to finance a domestic expansion. The result was growing budget and current account deficits, leading to a balance of payments crisis. The external debt was rescheduled in 1970. Like Soeharto, Marcos had early experience with the potential pitfalls of foreign borrowing, but his caution lasted only until the late 1970s.

The second period, from 1970 to 1972, included an economic stabilization plan supported by the IMF. Devaluation, together with tight monetary and fiscal policies, resulted in a sharp reduction in real wages and an increasingly violent political situation. However, strong export performance helped to revive economic growth.

From 1972 to 1979, Philippine economic performance looked strong. Real growth rose to 6.2 percent per year, nontraditional exports increased, and investment boomed. However, these statistics mask underlying economic difficulties which help to explain the reversal after the second oil shock. In particular, total exports failed to grow as a share of GNP as traditional exports declined. Investments undertaken produced very poor returns and labor productivity actually declined. Much of the explanation for the system's fragility comes from delayed exchange rate adjustments, disincentives for traditional export sectors, and the uncertainties and misallocations inherent in the government's growing "crony capitalism" which favored certain industries and individuals for political reasons.

The situation deteriorated during 1979–82. The Philippines was hit hard by the second oil price shock. However, unlike Korea and Indonesia which had undertaken stabilization measures even before the shock, the Philippines reacted with expansionary policies to counteract the contractionary effects. External borrowing soared to finance public investment projects, some of which never materialized. Increasingly, borrowing was short term. The value of exports fell sharply, budget and current account deficits continued to grow, and capital flight exacerbated the balance of payments difficulties. In October 1983, when reserves were nearly depleted, the Philippines declared a debt moratorium. During 1983–85, harsh austerity measures were undertaken. Inflation was reduced and the current account deficit nearly eliminated, but the output costs of stabilization were very large. Per capita income levels plunged to as low as those in the mid-1970s, and investment fell by more than half. The severe economic situation contributed to the defeat of Marcos in 1986.

The new government of Corazon Aquino continues to struggle to revive growth. Many of the remaining problems are microeconomic. However, the case of the Philippines also points to the difficulties in achieving sustained growth in an economy where domestic residents have grown wary of investing their resources at home and where investment has been slashed to improve the trade balance. In contrast, Korea's ability to reverse negative growth rates quickly is caused in large part by its history of consistent and credible policies and by the persistently high rates of fixed capital formation, even in the midst of the 1980 crisis.

Mexico

Mexico's recent economic performance raises the question why a windfall in oil revenues should result in stagflation and a debt crisis. Buffie cites the "sustained bout of extraordinary fiscal indiscipline" as the major factor, and argues that the subsequent stabilization effort, which has contributed to the collapse of investment, is ill conceived. Again, microeconomic distortions are part of the story, but the keys are poor exchange rate and fiscal policies.

Buffie's analysis contrasts Mexico's post-1972 performance with the high growth, low inflation period (1958–72). In the earlier period, fiscal expansions were short lived and macro policy was managed with an eye to maintaining a stable exchange rate. Two cycles of expansion were followed by macroeconomic crises. The first was generated by rapid fiscal expansion, financed in large part by central bank credit. Initially the expansion stimulated growth, but then inflation accelerated, the real exchange rate appreciated, the current account worsened, and capital flight erupted, financed by rapid debt accumulation. The result was a balance of payments crisis in 1976. A large devaluation and an IMF program of monetary and fiscal austerity followed, but the down side of the cycle appeared in 1977 as inflation surged while employment declined.

Recognition of Mexico's oil wealth, together with easily available external credits, was used to launch an even larger fiscal expansion in 1978–81. As with the inflow from worker remittances in Turkey, the windfall was used to avoid, not to facilitate, a deeper structural adjustment.

Again, the expansion generated strong growth in output and employment and high investment, but was unsustainable. Buffie points to three major flaws in the policy. First, public sector revenues, net of transfers of nonparastatals, declined despite the large oil revenues. The tax base was small and shrinking. Second, despite the dollar earnings from petroleum exports, the current account deficit deteriorated. Trade liberalization along with real appreciation generated an import boom and stagnant nonoil exports. At the same time, expected devaluation and lack of confidence resulted in large outflows of private capital. External debt was rapidly accumulated. A third factor in the program's unsustainability was the growing concentration in short-term debt. Unfortunately, the debt did not primarily finance investments which could generate foreign exchange earnings and sustain growth. Much of the increase in public outlays went to current expenditure, while many of the investments in state-owned enterprises later proved unsound.

As Mexico became unable to service its debts in 1982 and additional foreign loans dried up, the boom again turned to stagflation. Although the fiscal expansion continued and inflation soared, large real devaluations and trade restrictions cut imports, including intermediate inputs. Four years later, in 1986, Mexico's real output was below its level at the beginning of adjustment.

In 1982–84 a severe austerity program was put into place. The current account improved, and there was some reduction in the budget deficit. However, inflation remained high, real GDP fell substantially, and private investment collapsed. The investment decline in Mexico, as in Argentina, was caused by sharp reductions in available credit, together with high prices of capital goods and imported intermediates. There was no progress in reducing the budget deficit, as tax revenues remain stagnant and little effort was made to broaden the tax base. The deficits were financed largely by government bond sales, raising real interest rates, and contracting credit available to the private sector.

The collapse of oil prices on the world market in 1986 brought renewed austerity. Again, output declined while inflation jumped. The severe terms of trade deterioration compounded the difficulties of Mexico's stabilization and structural adjustment.

Argentina

Dornbusch and de Pablo study the Argentine debt crisis from the perspective of the country's long history of macroeconomic instability and political uncertainty coupled with the particular dynamics of debt, deficits, and inflation. They conclude that policy and economic structure eventually would have led to a debt crisis; the external shocks of the 1970s and 1980s merely brought the crisis on sooner. Again, both fiscal and exchange rate policies were central. A massive overvaluation in the late 1970s created a large external debt. Despite aggressive exchange rate management, the difficulties were compounded in the 1980s as the budget deficit mushroomed out of control.

The late 1970s were a period of relative macroeconomic stability for Argentina. Finance Minister Martinez de Hoz had brought inflation down from 2,000 percent in 1975 to 100–200 percent in 1976. Similarly, the budget deficit had been reduced from 15 to 7 percent of GDP. In an attempt to reduce inflation further, Argentina introduced a new exchange rate regime in 1979. The exchange rate depreciation was to be preannounced, and capital markets were opened fully in the hope that international competition would discipline domestic price setters. While inflation did fall, the cumulative real appreciation exceeded 50 percent by the end of 1980. In anticipation of a maxidevaluation, there were massive capital outflows and accumulation of external debt.

A series of large devaluations between 1981 and 1982 restored the real exchange rate to its 1976 level. However, the Argentine story differs strikingly from that of Indonesia, Korea, and Turkey, where large devaluations set the stage for rapid growth in exports and GNP, easing the burden of external debt repayment. Instead, Argentina's economic performance deteriorated substantially during 1981–83. Despite the large exchange rate adjustments, external debt accumulation accelerated, real growth turned negative, and inflation soared.

There are three main reasons why the devaluations did not generate export-led growth as had occurred in Turkey and Korea. First, Argentine exports did not respond quickly to the real depreciation as they had in Turkey because of sluggish world demand and a more fragmented export sector. Second, and more importantly, Argentina was not given the "breathing space" of continued capital inflows in the first years of adjustment which had eased the adjustments in Indonesia, Korea, and Turkey. Argentina was forced to reverse its current account quickly, from −6 percent of GNP in 1980 to 3.6 percent of GNP during 1982–83. The improved external balance was achieved by cutting imports in half and through reduced investment and a domestic recession.

Third, Argentina's budget deficit more than doubled during 1981–83, while Korea, Turkey, and Indonesia all undertook fiscal corrections. Reasons for the increase included the government's unwise exchange rate guarantees, which deteriorated the budget as additional devaluations were required, and the military conflict in the Falklands.

Dornbusch and de Pablo emphasize the interaction between the inflation explosion and the government budget deficit, which averaged 18 percent of GDP during 1981–83. Rising real interest rates and exchange rate depreciation increased the government's debt service obligations and thereby the budget deficit, leading to additional money creation and fueling inflation. The process was exacerbated as institutional changes provided additional interest-bearing substitutes for money. As Alfonsín took office in 1984, large wage increases put further pressure on the budget and inflation accelerated. By the end of 1984, Argentina seemed to be headed toward hyperinflation.

The Austral Plan, a heterodox shock treatment launched in June 1985, succeeded in bringing inflation down to 100–200 percent. The plan included a wage and price freeze, a promise not to create money to finance the deficit, and a rescheduling agreement with creditors. However, the budget deficit remained at 5 percent of GNP, while net private investment turned negative. Fiscal reform, especially broadening the tax base, remains an important issue on Argentina's agenda.

Brazil

Brazil's experience combines elements from Korea, Turkey, Mexico, and Argentina. Like Argentina, Brazil has a long history of inflation, debt, and macroeconomic crises and stabilization plans. Cardoso and Fishlow argue that external debt shifted from being part of the solution to attaining sustainable growth to being part of the problem.

The years 1968 to 1973 were a period of strong growth. Import substitution coupled with some export promotion and financed by foreign borrowing seemed to be working well. When the first oil price shock hit, there was little political support for an orthodox policy response. Instead, Brazil elected to continue the expansion and embarked on a National Development Plan which stimulated public investment and stressed import substitution. It relied on external funds to avoid passing external price increases through to domestic consumers and to maintain domestic demand. Widespread indexation made the rising inflation tolerable. As the current account deteriorated, the government relied increasingly on direct market intervention and controls to restrict imports. While the real exchange rate was kept relatively constant, few incentives were created to encourage exports. Thus, when the second oil price shock hit, the Brazilian economy was in a precarious position.

In some respects, Brazil's experience in 1974–78 paralleled the Korean experience. Korea also decided to borrow through the oil shock, without altering its plans to invest in heavy and chemical industries. As difficulties emerged, government intervention and import restrictions increased. However, there were also some important differences. Korea passed through the external price changes. Many more of Korea's investments were in exportable industries, which would later generate foreign exchange to help repay debts. Also, Korean domestic savings rose during periods of strong growth, helping to finance the investments. Finally, Korea began to reduce government direct intervention and the size of subsidies to special interests before the crisis became serious.

Brazil attempted to implement an orthodox program, including fiscal reform, in March 1979. However, the approach was labeled "recessionist." A heterodox plan resembling the Argentine approach to inflation reduction through preannouncing the exchange rate devaluation was adopted instead. The program maintained real growth, inflation rose, the real exchange rate appreciated, and a massive current account deficit led to rapid debt accumulation. The plan was abandoned at the end of 1980 under pressure from foreign creditors. Thus, like Korea, Brazil suffered a debt crisis in 1980.

Restrictive macroeconomic policies in 1981 resulted in a recession along with a trade surplus, restoring Brazil's access to international capital markets. However, Brazil's policy lacked attention to medium-term structural adjustment, and an opportunity was lost to put the economy back on track. The public deficit rose, the real exchange rate appreciated, and exports declined, forcing Brazil to go to the IMF and reschedule its debts.

Under a series of IMF programs during 1983–84, Brazil managed to overfulfill external balance targets and to revive growth of exports and output, but inflation persisted. Cardoso and Fishlow believe that the policies pursued to generate trade surpluses to service the debt also fueled inflation. They emphasize the switch from external debt finance of the budget to internal debt finance which pushed up domestic interest rates, feeding the budget deficit and lowering investment. At the same time, agressive devaluation fueled inflation in the highly indexed economy. Brazil's inertial inflation differs strikingly from inflation in Korea and the Philippines.

At the same time, the government was unable to raise tax revenues, a problem shared by Argentina, Mexico, and the Philippines. Fiscal policy played a central role in Brazil's transition from a "successful debtor" in 1984 to a "problem debtor" by 1986.

Internal problems, especially inflation, were the dominant concern, not external factors. Brazil also launched a heterodox plan to stop inflation in 1986. The Cruzado Plan did stop inflation initially, but the gains were short lived. As November elections approached, fiscal policy became expansionary and monetary growth accelerated. When the price freeze was no longer capable of containing the repressed inflation, the entire program fell apart and inflation reached 800 percent by mid-1987. Cardoso and Fishlow again emphasize the need for budget corrections and for revived investment expenditures, if Brazil is to achieve growth with financial stability.

Common Themes

There are many similarities between countries which did relatively well and those which are still struggling to resume growth with low inflation. Even Korea, Indonesia, and Turkey (the "high growers"), which grew at moderate to high rates and avoided rescheduling in the 1980s, have been forced to readjust economic policies in the face of external shocks and poor economic performance.

Strikingly, external shocks were not the primary cause of economic difficulties in either the high growers or the debt reschedulers. Nor do the differences in the magnitudes of those shocks differentiate between the two groups. In all of the countries studied, problems emerged because domestic policies were ill suited to cope with external conditions. In Korea's 1979–80 crisis, external (and internal) shocks were compounded by heavy imports, overvaluation, and increased fiscal deficits associated with the Big Push of the 1970s. In Turkey and Mexico, a foreign exchange windfall, not negative external shocks, set the stage for unsustainable fiscal expansion, real appreciation, and debt accumulation. In contrast, foreign exchange inflows in Indonesia led to a fiscal expansion, but not to a surge in foreign borrowing.

Six Lessons

There are six important differences between those countries which rescheduled in the 1980s and those which did not. First is the importance of the breathing space which some countries had at the initial stages of the adjustment. None of the three high growers undertook a structural adjustment at the same time that it converted its external deficit to a surplus. In all three cases, financing was available to maintain investments and to stimulate growth while the current account deficit was reduced. Indonesia received generous official assistance in the mid-1960s. Turkey received substantial foreign inflows after its 1977 crisis. Korea continued to borrow heavily in international capital markets during 1979–81. These countries all ran into difficulties before the magnitude of the crisis became evident and before lending to developing countries contracted in 1982.

Second, the successful countries maintained high rates of capital formation. They avoided cuts in investment and encouraged investment in export industries. When world demand conditions were favorable, they were in a prime position to expand their exports rapidly. Of course, high rates of investment are not enough to ensure high rates of growth, especially if there are severe microeconomic distortions. The Philippines during 1979–83 provided a stark example of very high incremental capital output ratios when capital accumulation was concentrated in industries with low or negative value added at world prices.

Third, the successful countries maintained stable and competitive real exchange rates. Indonesia's aggressive exchange rate policy kept nonoil exports competitive. Korea maintained a relatively stable and competitive real exchange rate. Devaluations in Brazil, Indonesia, Korea, and Turkey were successful in expanding exports, although sometimes with a lag.

Fourth, the importance of fiscal discipline and a strong tax base stands out from the country experiences. In Korea, budget deficits above 4 percent of GNP were considered very large and lasted for no more than two consecutive years before being reduced to 1–2 percent of GNP. Revenues were maintained and increased through the introduction of a value-added tax and other taxes. Korea's public sector also contributed to a high saving rate. In contrast, Argentina has not had a budget deficit below 4 percent of GNP since 1970. The deficit reached 18 percent of GNP during 1981–83. In both Argentina and Brazil, the budget deficit played a central role in debt accumulation and rising inflation. How to broaden and deepen the tax base has plagued these two countries as well as Bolivia, Mexico, and the Philippines.

The timing of policy response to external shocks is a fifth important factor. Indonesia and Korea initiated adjustments because of undesirable domestic performance even before a crisis emerged. Arguably, Brazil could have avoided much of the 1981–83 recession if it had undertaken policy adjustments in 1979.

Finally, both Korea and Indonesia have enjoyed trend increases in domestic (especially private) savings. The rising saving rate enabled these countries to finance high rates of investment with declining reliance on foreign borrowing. It is not clear, however, how much of the saving behavior is attributable to government policies and how much to social and political factors.

Tradeoffs in Economic Policy

A final theme which runs throughout the country case studies is how to allocate domestic resources among consumption (public and private), investment, and net resource transfers abroad. In the years preceding a debt crisis, the typical pattern has been an inflow of resources from abroad allocated to a combination of higher domestic consumption and higher investment. In Korea, the resources went primarily to investment. In Mexico and the Philippines in the early 1980s, a large part of the resources went to increased consumption.

Difficult policy decisions arise when the net resource transfer must go in the other direction, to repay debts. If consumption is to be squeezed, it also matters how the transfer is achieved. Alternatives include inflation, as in Argentina, Bolivia, Brazil, and perhaps Turkey in the late 1970s, income taxes, and cuts in government expenditures. The alternatives can have widely different distributional consequences. However, for political as well as economic reasons, there are limits to the amount consumption levels can be squeezed in already poor countries.

This perspective highlights differences in the adjustments across countries. Initially, Korea and Indonesia were able to maintain investment because the net resource inflow continued. Over time, real growth stimulated domestic savings, reducing private consumption as a share of GNP. The "lower" consumption substituted for net inflows from abroad by freeing resources for investment. In Argentina, Bolivia, Brazil, Mexico, and the Philippines, the reversal of net resource inflows led to cuts in investment and private consumption to contain imports. Growth slowed and there was no rise in private savings to ease the transfer burden. Thus, there are strong arguments for reducing debt repayments in order to stimulate investment and growth. The tradeoffs involved in allocation of domestic resources are at the heart of the debates over schemes for debt reduction. The lesson which emerges strongly from the NBER country studies is that, while capital inflows are no panacea and need not lead to investment and growth, it is unrealistic to expect countries to revive growth without some "breathing space" while they initiate structural adjustments.