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THE SLUMP OF 1980 AND THE THIRD WORLD

Predictions in a best-selling novel of 'the crash of '79' were fortunately not borne out. But the world economy did turn down last year and is clearly headed for a slump in 1980 and beyond. That this means losses of output, employment, and income in the Western industrial countries (dcs) is well known. But it also has serious implications for the non oil-developing countries (ldcs) which are less widely understood. The purpose of this Briefing Paper is therefore to examine the consequences of the world slump for the Third World and the policy issues which arise. However, the present downturn can only be understood in the context of events during the 1970s. We start therefore, with an examination of those experiences and their implications for the present.

The 1974-75 slump and its aftermath

Recession in the dcs

The economic recession of 1974-75 can be described as the first general slump since the 1930s. Some dcs were worse hit than others, but few escaped a downturn in economic activity. The quadrupling of crude oil prices at the end of 1973 was the decisive event. It plunged the dc balance of payments heavily into deficit, and the resulting major shift in the terms of trade had the effect of a large transfer of real income to the OPEC countries from the rest of the world – a transfer which was largely from dcs, most of whose productive structures are especially dependent on oil imports.

The OPEC decision had wider ramifications too. There were the normal multiplier effects of the initial losses of income. The expansion of world trade was badly affected. Higher oil prices added further stimuli to an inflation which had already accelerated substantially during 1973. Organized labour and other interest groups tried to evade reduced real incomes by seeking higher money incomes and this added further to the inflationary process. Profits were squeezed and the growth of private investment was sharply reduced. Many governments opted for deflationary fiscal and monetary measures, which further depressed economic activity.

The results for the dc bloc (although with considerable variations between countries): a worsening in the aggregate current payments deficit during 1974 of \$35 billion (see Fig 1); large losses of output, with absolute declines in average real per capita GNP in 1974 and 1975 (see Fig 2); losses of jobs, with the unemployment rate rising from 3.0% in 1973 to 5.1% in 1975; price rises, with inflation nearly doubling between 1973 and 1974.

After 1975 there was a partial recovery. Growth rates rose (Fig 2), although not to their 1972-73 levels. Inflation began to fall but remained at historically high levels and began creeping up again in 1979. Private investment remained depressed. Unemployment rates continued at levels far above the norm established in the 1950s and '60s. The volume of world trade continued to falter, growing at less than half its pre-1974 pace. The industrial world thus entered the slump of 1980 having only half recovered from the last one.

Figure 1: The global balance of payments

(balance on current account, excluding official transfers; \$ billion)

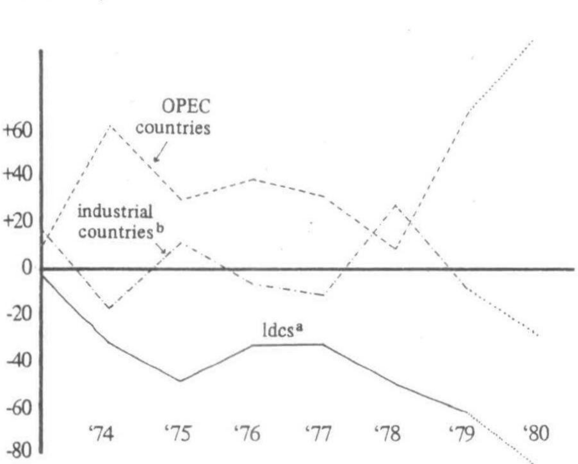
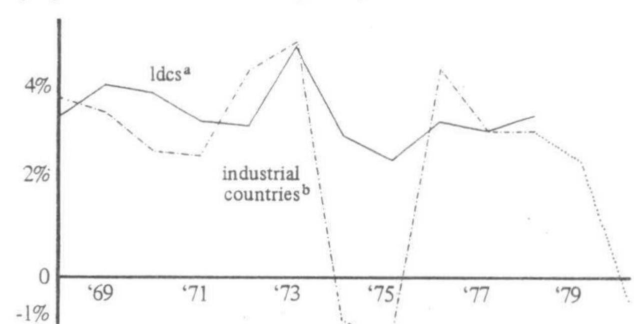


Figure 2: The growth of per capita GNP

(% per annum in constant prices)



Notes to Figures 1 and 2:

a Developing countries, excluding oil-exporting countries.

b Members of OECD; includes all major Western industrial countries.

Finely dotted lines indicate approximate forecasts, derived from OECD and other sources.

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Consequences for Third World growth

The 1973 oil price rise had effects in the ldcs (ie *non-oil* developing countries) similar to those just described for the dcs. Here too, the payments and terms of trade effects imposed real income losses, although these were relatively less serious for ldcs because their productive systems and external payments are much less dependent on fuel imports (in 1977 net fuel imports into ldcs were equal to only 6% of total imports, against 17% for dcs). In addition, however, the ldcs were adversely affected by the depression in the dcs. Nearly two-thirds of all ldc trade is with dcs so when the industrial world sneezes the ldcs are certain to catch cold.

Depression in the industrial world induced sharp falls in the world prices of many of the primary product exports on which the majority of ldcs still depend. However, these prices entered the slump at record high levels, and both the extent and duration of the subsequent fall was limited, partly as a result of stockbuilding by dcs. The ability of the dcs to pass on their own inflation in higher export prices was perhaps more damaging. Ldcs were faced with two sources of imported inflation: the direct effects of higher oil costs; and rising prices for their imports of manufactures, whose prices rose by 40% in 1973-75. With export prices rising more slowly, the terms of trade of ldcs (export prices relative to import prices) worsened by an alarming 12% in 1974 alone, followed by a further but smaller deterioration in 1975.

With the economies of many ldcs remaining highly dependent on international trade, and with development often constrained by shortages of foreign exchange, it is not surprising that the deterioration in their balance of payments led to slower growth in per capita GNP (Figs 1 and 2). Starting with an unusually small current payments deficit of $12 billion in 1973, this grew to $47.5 billion two years later, improved somewhat in 1976-77 and then worsened rather sharply again in 1978-79. Similarly, the estimated expansion of incomes fell from an average of 3.7% in 1970-73 to 2.5% in 1975, before partially recovering in 1976-78.

In the circumstances, their overall growth rate of 3% per annum in 1974-78 was not unsatisfactory, a result assisted by ldcs' limited reliance on fuel imports, favourable weather, and an ability to bolster imports by borrowing abroad. Indeed, the relative buoyancy of the Third World helped the dcs pull out of their depression. But there were considerable differences within the Third World. Developing Asia, especially the richer countries, actually accelerated growth. In Latin America and Black Africa it was a different story. The growth of per capita incomes in Africa was only about 1% per annum in 1974-78 (although the data are admittedly weak), against nearly 3% in 1967-73.

Recycling, reserves and debt

In both dcs and ldcs, the more extreme prophecies of doom following the oil price rise were falsified by an ability to finance a large part of their current payments deficits by borrowing. Much of the current account surplus of the oil-exporting countries – which increased by $60 billion in 1974 alone and remained above $30 billion annually for almost all the remainder of the decade (Fig 1) – was recycled to some of the deficit nations. This chiefly took the form of a massive re-lending of OPEC Eurodollar bank deposits to deficit countries. The net total of international bank credit is estimated to have increased from $170 billion in 1973 to $650 billion at end-1979. Oil-exporters also made large direct investments in several industrial countries, stepped up their aid to ldcs and made modest sums available for re-lending by the International Monetary Fund (IMF) and the World Bank.

Some ldcs were able to borrow large sums through these recycling arrangements, with about $150 bn being lent to Third World countries. There were also substantial nominal increases in aid flows. Total overseas development assistance from all sources to all ldcs is estimated to have gone up from $11.6 billion in 1973 to $21.9 billion in 1978. This is misleading, however, for there was actually a fall in the quantum of imports this aid could buy. When deflated by an index of ldc import prices, the real value of aid fell by 6% in 1973-78. Aid also fell as a proportion of dc incomes to its present level of one-third of one per cent of GNP.

Nevertheless, some ldcs were able to cover the increase in their current payments deficits by borrowing more from the rest of the world. Indeed, some were able to add to their international reserves. It is important, however, to keep these acquisitions in perspective. Much of the borrowing was on medium-term, commercial-interest terms so the apparent strengthening in their reserve position was in some degree illusory. In fact, ldc reserves net of private foreign indebtedness declined sharply and the burden of debt servicing (ie repayments and interest payments) began to rise. Moreover, even the gross increase in reserves was not sufficient to match the rise of import prices.

As a percentage of export earnings, the debt servicing costs of ldcs increased from a trough of about 8% in 1974 to about 13% in 1978 (see *Briefing Paper No.3 1978* on 'Debt and the Third World'). Furthermore, there is a large bunching of repayments during the next two or three years, with nearly 50% of total ldc debt at the end of 1977 being due for repayment in 1978-82. Increasingly, ldcs are using their export earnings to meet debt obligations, or are incurring fresh debts for the same purpose. The strains this is placing on their economies is illustrated by an IMF figure that the number of ldcs with arrears on current payments, or seeking to re-negotiate their debt obligations, grew from 3 in 1974 to 18 at end-1978.

The extremely uneven access of ldcs to recycled OPEC surpluses is of even greater concern. For example, of total international Eurocurrency lending in 1978-79, only 30% went to ldcs; of this, Brazil and Mexico alone obtained almost half; they and three others received almost three-quarters. It was these, mainly middle-income, ldcs which were best able to afford the imports required for development. For most of the post-1973 period, the majority of low-income ldcs had to manage with a smaller per capita quantity of imports than ten years earlier. With important exceptions like India, it was in this group of countries that growth rates were most severely affected.

Current prospects

Another slump in industrial countries ......

There is no doubt that the industrial world has moved into another recession but there is disagreement about its likely magnitude. There are a number of factors at work, not all pulling in the same direction:

(a) Most dc governments still regard inflation as Enemy No 1, in the control of which they are willing to sacrifice output and employment. Restrictive fiscal-monetary policies are in force, with interest rates still rising. This will likely place a further damper on investment, which has never recovered its pre-1974 dynamic.

(b) Oil prices have been rising fast again. Relative to the export prices of industrial countries, the price of oil stabilised after 1973, and even declined in 1977-78. But during 1979 the average price rose from $12.9 per barrel at the beginning of the year to about $22.7 immediately prior to the December OPEC meeting (which failed to agree new uniform prices). The beginning of 1980 saw a new flurry of increases and by early February the average had probably gone up to at least $30, and was still rising. Although a 130% increase is milder than the 1973-74 experience, the effects of a given percentage rise are now more adverse. The volume of imports of the oil-exporting states rose by a phenomenal 24% per annum in 1973-78 but the widespread belief that such a rate of expansion cannot be sustained into the 1980s has been given weight by the news that the volume of their imports actually fell back a little in 1979. There is thus a genuine risk that a smaller share of the additional oil revenues will find their way back to the dcs as export sales, with a corresponding loss of total demand, and that OPEC payments surpluses will prove more persistent than they did in the 1970s. Moreover, the share of oil in the total value of dc imports has almost doubled since 1973, which increases its impact on domestic activity.

(c) Factors suggesting a milder recession this time, however, are that dc inflation is generally slower than in 1973-74, as is the rate of monetary expansion, and the real price of dc non-oil commodity imports is lower.

The Organization for Economic Co-operation and Development (OECD) has thus made forecasts for 1980 which envisage smaller losses of output during the current recession (see Fig 2) when compared with 1974-75, although with considerable variations between countries. They also forecast major declines in the growth of consumption, industrial production and GNP, worsening unemployment and accelerating inflation. And while the payments surplus of the OPEC group soars to a new record, the dcs will plunge heavily into deficit again (Fig 1). OECD does not commit itself beyond 1980, but the prospect of continuing large OPEC surpluses, the unresolved struggle against inflation, and the depressed investment rates of the last few years will all tell against rapid recovery.

...... and its impact on ldcs

Where is this unhappy prospect likely to leave the ldcs? The real prices of ldc commodity exports are far below the 1973-74 peak but they too will have inflated oil bills and can expect higher energy costs in the dcs to give a further boost to the cost of industrial imports. They will gain little directly from the increased purchasing power of oil-producers but demand for their exports will be hit by depression in the industrial world (OECD estimates that every percentage point reduction in dc growth reduces the export earnings of ldcs by over $2 billion). So their terms of trade will worsen once more and their payments deficit – already large in 1979 – is expected to plunge to a new record (Fig 1), equivalent to a third of their export earnings.

It is possible to argue that the ldc bloc might not be too badly affected by these influences. The industrial recession may be milder, ldcs possess an increased nominal value of international reserves, and there will again be a recycling of OPEC surpluses to partially cover ldc deficits. On the other hand, it is shown above that the apparent increase in reserves is largely illusory. And while ldcs entered the 1974-75 slump with a relatively modest payments deficit of $12 billion and high export prices, their deficit in 1979 was $60 billion and their real export prices were well down. It seems likely, therefore, that more ldcs will experience payments crises and, for reasons taken up shortly, there may be great difficulties in recycling oil surpluses to deficit ldcs. Not surprisingly, therefore, OECD has warned that developing countries may be much harder hit than in 1974. Moreover, the depressing effects on their growth are likely to extend well beyond 1980, especially if large OPEC surpluses do prove more persistent.

It is, however, unsatisfactory to treat ldcs as a uniform grouping because, once again, the adverse impact of the slump is likely to be borne more heavily by the poorer ldcs. These countries do not enjoy high credit ratings and can expect limited access to commercial bank loans. They will continue to depend on aid as their chief source of payments support, but if the real value of aid continues to decline this will leave them little alternative to cutting the quantity of imports. Since their per capita imports are already less than 10 years ago, and a wide range of capital and intermediate goods imports are needed for the development effort, the effect of further cuts would be serious. It would not take much to eliminate altogether the annual one per cent growth of per capita incomes in Africa, with all that means for human hardship and frustration.

Middle income ldcs, including most of the newly industrializing countries, face rather different problems, especially serious for countries like the Philippines which have only recently begun to succeed as industrial exporters:

(a) Demand for their manufactured exports is likely to be worse affected than for the primary product exports of most of the poorer ldcs.

(b) Rising unemployment and falling incomes in the dcs may give further impetus to the recent growth of dc protectionism in such industries as clothing, footwear and steel.

(c) This group may find it increasingly difficult to continue to finance current deficits by large new net borrowings from the international banking system. The few ldcs which were able to borrow large sums from the banks in the 1970s were then too successful in their search for credit, in the sense that the banks now show signs of being increasingly wary of extending large new net credits. Although debt ratios can mislead, the fact is that the cost of servicing the external public debt of the Latin American region had risen to the equivalent of 21% of exports by 1977, with several individual countries having much higher ratios.

Middle-income ldcs are thus faced with the danger of joining the poorer members of the club in having to cut back on imports – and on development – during the next few years.

Implications for policy

The situation just described throws up policy issues for the international community, which can be grouped under three problem-areas: the deflationary bias in the world economy; the recycling of OPEC surpluses; and aid to the developing countries.

The problem of deflationary bias: The post-war system of international trade and payments has had a deflationary, anti-growth bias. This is because there are no effective sanctions to require countries, which persist in running payments surpluses, to stimulate their economies and their import demands. Their surpluses impose matching deficits on the rest of the world, which then has to cut back on economic expansion in attempts to reduce imports and restore health to its external payments. That such a bias hurts countries pursuing economic development is obvious.

But to this bias has been added a more recent twist, resulting not only from the sheer size of the OPEC surpluses but also from the way in which the dcs responded to the initial OPEC price hike. Starting with already rather rapid inflation, countries such as the UK and US have relied heavily on restrictive fiscal and monetary measures to cut back on demand and improve their inflation and payments situations. They have been less vigorous in restructuring their economies to depend less on imported fuels. Responding to supply-induced shocks by cutting back on demand has been a high-cost way of dealing with the oil crisis. A preoccupation with inflation has foreclosed the option of using growth to restructure their economies.

The success of international banks in recycling OPEC surpluses further reduced the pressure for structural adaptation, in developing as well as industrial countries. There has been more financing than adjustment: borrowing abroad has been used to defer necessary – inevitably painful – changes at home. Solutions would involve greater determination at the national level to implement serious energy-conservation programmes and other measures of structural adjustment. But the world deflationary bias would be reduced if there were more effective international co-ordination of national policies in an increasingly interdependent world. Fuller recognition of the adverse global effects of deflation and protection should also lead to a re-examination of policies in the industrial world. Hopefully the *Brandt Report* (see *Briefing Paper No 2 1980*) will provide a stimulus for world leaders to look afresh at these questions.

The recycling problem: At the time of the 1973 oil price increase there were many who feared that the international monetary system would be unable to cope with the resulting massive financial flows. They were wrong. The system successfully re-lent large OPEC surpluses to deficit countries. A massive increase in commercial bank lending was particularly important to this success. But access to their credit was very uneven; many of those with the most acute payments difficulties received little or none, especially the poorer ldcs, and only a few ldcs received much.

This concentration of risks on a small number of ldcs suggests that it will be more difficult in future for the banks to undertake large new *net* lending to the Third World. Indeed, several major international banks have already been advised by their home central banks that it would be dangerous to extend much more credit to ldcs. The OPEC surpluses will not be buried in the sand but it is in the industrial countries that the bulk of them will be invested.

There are other dangers too. There is no control over the quantity and prudence of inter-country bank lending comparable in effectiveness to the controls exercised by central banks within national frontiers. The international banks are in the dangerous business of borrowing short and lending long, and observers are sounding the alarm over the vulnerable and fiercely competitive state of international banking. Repudiation of debts by Iran and President Carter's decision to freeze Iranian bank deposits sent out further shock waves. Now the bankers themselves are becoming worried. In an unsettled world and in the absence of effective regulation, the risk of a major failure among international banks cannot be ruled out – a failure that could have calamitous results throughout the world economy. In this area, at least, there is a strong and immediate community of interests between dcs and ldcs to strengthen the existing system, and the urgings of the *Brandt Report* are particularly apposite.

A logical response to unequal access and the absence of effective regulation would include an increased role for the IMF. Partly because of its own restrictive rules, the Fund has made only modest contributions to the easing of ldc payments difficulties since 1973. Indeed, there was a net return flow to the Fund in 1978-79. Were it to liberalize its rules – and it has been moving cautiously in that direction – the conditions could be created for the Fund to begin, if only informally, to fill the vacancy for an international bankers' bank – keeping a watching brief over commercial bank lending and seeking ways of meeting the financing needs of countries with the severest payments difficulties.

The aid problem: A global balance of payments in which oil-exporters earn huge current surpluses and in which many developing countries are likely to run into acute foreign exchange shortages naturally focusses attention on aid flows from oil-exporters. The nominal value of disbursed aid from the OPEC countries more than quadrupled in 1973-77, reaching almost \$5 billion in the latter year. It declined to \$3.7 billion in 1978, however, and by that year the purchasing power of the aid was only half the 1975 level. The extent to which these countries use their surpluses to make grants and soft loans – and their willingness to do so to a wide range of ldcs – will test the sincerity of their protestations of solidarity with the rest of the Third World.

But the industrial nations also have a major responsibility in this area. The real value of their aid has been declining too and, in relation to GNP, is only half the UN target level. But quite apart from this, the logic of a situation in which the dcs have large-scale access to recycled oil surpluses and most ldcs do not, is that very large sums will need to be 're-recycled' as balance of payments support for the worst affected ldcs. Unless this happens, it is difficult to see how the developing nations can avoid the most damaging consequences of world trends almost entirely outside their control.