As we all know—the there was a loss in momentum of worldwide economic recovery during calendar year 1985. Growth of world output declined from 4.3 percent in 1984 to 2.7 percent in 1985. The United States, Germany, and Japan (among the industrial countries) also are part of the trend which has persisted into 1986. This continuing drift downward is particularly troublesome because lower interest rates and the decline in oil prices were expected to stimulate greater economic activity in the industrial countries.

There was an appreciable slowing of growth in world trade in 1985 and no improvement is expected in that rate for 1986. The growth of industrial country import volume fell from 13 percent in 1984 to 5 percent in 1985 and developing country export earnings have stagnated.

On a more positive note, the recent decline in international market interest rates has brought welcome relief to those countries saddled with dollar-denominated debt. Yet, these rates are still historically high and exceed the average rates of GDP real growth in developing countries.

Less encouraging is the primary commodity price decline. Non-oil commodity prices are at an all-time low and these prices are still falling. Oil prices, also lower, have hit some heavily indebted oil exporters very hard while helping net oil importers worldwide. On the other hand, prices of manufactures exported to developing countries are rising. Consequently, many developing countries can expect a deterioration in their terms of trade this year.

Net long-term capital flows to developing countries—continued their
four-year decline into 1985, reaching $35.5 billion—less than half the 1981 level. For the heavily indebted developing countries, net inflows of capital in 1985 were a quarter of what they were in 1981.

The net effect of these trends is that 1986 GDP growth in the heavily indebted countries may well fall even lower from the 3.2 percent registered in 1985. Again, there are important divergences among countries—such as Brazil, whose GDP growth may reach 6 percent this year—but the overall direction is not encouraging.

The protracted difficulties of the heavily-indebted middle-income countries have taught us all a salutary lesson: timely adjustment, together with adequate capital flows and an open trading system, is absolutely essential to sustained growth, restored creditworthiness, and the alleviation of poverty. On that there is now broad agreement. And on that there is at least an expressed collective will to promote and support such adjustment.

It can be argued that a measure of economic growth and poverty alleviation can result purely from internal adjustment. But the measure can never match the need. Sustained and adequate growth together with real progress in the alleviation of poverty cannot be achieved unless the industrialized countries play their required role. And that role is to adopt and implement policies that will create and maintain a trade and financial environment which is supportive of, and not inimical to, the growth objectives of the indebted countries. So let me turn now to the particular actions asked of them and seek to show just how crucial they are.

At the top of our list of priority actions stands the maintenance of a steady rate of real growth in the GNP of the industrial nations, creating durable non-inflationary growth in world demand. However, continued high budget deficits in some of the major industrialized countries are making it very difficult to sustain a steady rate of growth. The domestic effects of large and persistent deficits are principally on real interest rates and on inflationary expectations. There is surely no doubt that large deficits contribute to high real interest rates, and as these deficits climb, they are bound eventually to be accompanied by an accelerating rate of inflation and increased protection. The resulting stop-go policy mix that governments would adopt in their attempts to control either inflation, unemployment, or the trade deficit would inevitably slow world growth.
The message is clear: those economies with persistently high deficits must work to reduce them. And taking the route of public expenditure cuts seems the most appropriate approach. That is undeniably hard in political terms, especially if it involves cutting back on growth in social benefits, the second fastest growing item of public spending in the industrial world after defense. Governments should look to see whether, for example, expenditures on subsidies to manufacturing, especially in steel and shipbuilding, all in the name of easing structural change, are really to their long-term benefit.

Even more critically should they look at the rapid growth of subsidies to agriculture. Internal prices set well above world prices, especially in Europe but also here in the United States, encourage domestic production and depress domestic consumption. The resulting surpluses flooding the world at depressed prices do particular damage to developing countries trying to raise their output of agricultural products in which they often have a comparative advantage.

I know this is not an easy issue for those who come from America's farming heartland. But the issue must be faced.

The interaction between economic growth in the developing world and America's agricultural export opportunities is a crucial consideration. During the 1970s, developing country imports of wheat and coarse grains increased from 20.4 to 58.6 million metric tons per year. Over 70 percent of those imports were by the upper middle-income countries, such as Brazil, which were experiencing rapid economic growth. The agricultural export markets of the future will be found, not in the industrial economies, but in the fast growing developing countries of Latin America, Asia, and Africa.

The key to promoting rapid economic growth in the developing countries is the revitalization of agriculture. It is typically the largest sector in these developing countries, and raising its productivity is usually the only way that broad-based economic growth and a rise in per capita incomes can be obtained. And because low income groups spend a large portion of their individual incomes on more and better food, rapid economic growth and higher per capita income strengthen the demand for agricultural output in developing countries faster than it can be supplied domestically. This shortfall can only be met by imports.

Another important feature of successful economic development is that it typically leads to an upgrading of the diets of lower-income
countries. This means a more rapid growth in demand for poultry, livestock, and livestock products. The feed grains needed to produce more poultry and livestock are commodities for which the United States has a comparative advantage. As per capita incomes rise, the composition of demand also shifts from rice to wheat, and this too favors many U.S. producers.

At a time when the American farmer is enduring intense difficulties, such longer term perspectives regrettably are not an immediate antidote for his short-term problems. But these trends in developing country markets demonstrate that both the intent and effect of the World Bank’s agriculture lending, which has aroused some criticism in recent months—are not the enrichment of some farmers at the expense of others, but the promotion of growth—global growth—which will expand opportunities for all.

Cutting back farm subsidies is far from easy, but whatever route is taken, reduction in fiscal deficits is crucial, and the more the major industrial countries can manage to coordinate their macroeconomic policies, the less disruptive will be the process of reduction. Concerted intervention in the foreign exchange markets by the Group of Five to reduce the value of the dollar illustrates the potential usefulness of such cooperation. And the fall in interest rates is also a welcome indicator of new efforts at international cooperation to achieve macroeconomic adjustments.

Lower real interest rates are crucial to the debt-servicing capacity of the heavily indebted countries. The fall in dollar interest rates has been one of the few changes in the external environment of benefit to the developing countries in 1985 and 1986. But interest payments continued to absorb 36 percent of exports in the Latin American region in 1985. One percentage point knocked off the interest rate means a reduction in the region’s annual debt-servicing burden of more than $3 billion. And that really makes a difference.

Easing rigidities in labor markets to reduce high unemployment and to help stimulate new industrial capacity is another necessary area of adjustment for the industrialized countries if economic growth is to be sustained. Policies to encourage flexibility and reduce marginal labor costs need to be pursued. Training and mobility need to be improved, and reductions in the protection afforded certain industries will be necessary to promote the movement of labor into more efficient and competitive activities.

Correcting distortions caused by inappropriate fiscal and monetary
policies and labor rigidities can create the conditions for strong sustained growth in the industrial countries, and thus increase import demand among them and boost both exports and imports of developing countries. This in turn creates the conditions needed to reduce "international trade restrictions", as reduced they certainly must be.

An open trading system is essential to the heavily indebted countries, whose hopes of restoring their creditworthiness will be dashed if they cannot expand their export earnings. The current decline in the growth of developing countries' export receipts and the continuing deterioration in the overall trading environment is therefore alarming. The slow-down in the growth of Third World exports to the industrial countries just cannot be explained solely in terms of such factors as exchange rate movements, the phase of industrial country recovery, or supply factors. The rate of decline strongly suggests that protectionist measures, particularly in manufacturing and agriculture, are among the causes.

Especially worrying is the increasing use by industrialized countries of non-tariff barriers, which, like tariffs, are often more restrictive on those products of specific interest to the developing countries, such as agricultural and textile products. As I have said, agricultural exports are of vast importance for many developing countries. Yet hardly a day goes by without new calls in the industrial countries for more import restrictions on these developing country commodities. It is true of the United States, the biggest agricultural exporter in the world. It is even truer of the nations of the European Economic Community. Their import controls greatly harm the interests of agricultural commodity exporters of the Third World, not to mention the interests of consumers of all nations.

Unless trends such as these can be halted and reversed, severe global macroeconomic problems of both debt-servicing and growth lie ahead. In broadest terms, the principles underlying the General Agreement on Tariffs and Trades (GATT) and the multilateral trading system must be reaffirmed and adhered to. I am, therefore, greatly relieved by the prospective launching of a new round of multilateral trade negotiations under the aegis of the GATT. This new round is essential to the rolling back of protection, and it will need to take into proper account the legitimate concerns of the developing countries, such as I have just outlined, and the developing countries' own interests will be best served if they are integrally involved.
Commitments to a standstill in protectionism and to support for trade liberalization have been made again and again by the industrial powers. Yet, despite these commitments, the continuing erosion of the GATT system threatens to eliminate the last vestiges of order in world trading arrangements. Why is it that governments will not live up to their commitments? Dare we hope that such pledges as are made next month at the Punta del Este trade discussions will also be acted upon? We must earnestly hope so.

Let me now turn to the last, but by no means least important, of the areas of action to be taken by the industrial countries: the provision of capital. The restoration of economic growth in the highly-indebted middle-income countries and in the troubled low-income countries depends to a critical extent on the mobilization of additional capital flows from both private and official sources. For example, the World Bank has concluded that even with substantial policy reforms in the heavily-indebted middle-income countries, restoration of growth and creditworthiness over a five-year period would require, depending on the performance of the industrial countries, between $14 and $21 billion of net capital flows annually.

With respect to flows of private capital, the revival of commercial bank lending to the heavily-indebted middle-income countries undertaking growth-oriented medium-term adjustment programs is crucial. In his proposals at the Seoul meetings, Secretary Baker called for $20 billion in net new lending by the commercial banks in 1986, 1987, and 1988 in support of growth-oriented policies in the heavily-indebted middle-income countries. If they are to do this, the industrialized country governments must ensure that their regulatory authorities do not introduce conflicting signals. Certainly it is important to continue strengthening the banking system. We all benefit from that. But the measures intended for that purpose must not fly in the face of the need to restore growth in the debtor countries. I must therefore confess some concern over certain provisions of the tax bill in Congress which seem likely to discourage further commercial bank exposure in the indebted countries.

A return to voluntary lending by the commercial banks is an urgent requirement, and the trends so far have been disappointing. But, there are rays of hope. The acceptance by 50 banks lending to Mexico of the recommendation of the bank advisory group that they provide $500 million towards an emergency bridge loan of $1.6 billion to Mexico is encouraging. We must now hope that negotiations on the terms
and size of the commercial banks’ share of the $12 billion package in the works will be equally successful.

Let me insert here a word or two on what further role Japan might play in using its strong surplus position to bring capital to the countries that need it. There are good grounds for the view that, despite much advice to the contrary being offered to Japan, that country will not be able to rely increasingly on its domestic market for continued economic growth. A Japan that cannot export is a Japan losing its economic dynamism. And given the size of that economy, that spells a highly recessionary impact on the global economy. This means that Japan must continue to look for export markets. Expanding into Third World markets is one way of avoiding the problems involved in raising market share in the United States and Europe. And one way of reaching Third World markets is to provide them with the means to import. In other words: capital flows. Japan would find it very rewarding to increase the level of its capital flows to developing countries.

Japan has the ability to get capital to the Third World, owning today, as she does, 25 percent of total international banking assets. The United States comes second with 18 percent. But given the poor, and in many cases, deteriorating creditworthiness of the indebted countries, the Japanese banking system may hesitate to make major additions to its current exposure in the indebted countries without some form of governmental or institutional incentives. In this regard, mention has been made of the World Bank. It is my firm opinion, however, that the World Bank’s authority to guarantee third party loans to developing countries should be exercised only on an exceptional basis and as a last resort.

You will not be surprised if I now make a strong pitch for my former employer, the World Bank. The bank clearly has a central role to play as catalyst and coordinator, helping to bring together the main actors in support of medium-term adjustment programs in the indebted countries and providing, in close collaboration with the International Monetary Fund (IMF), its own expanded financial and advisory support.

The bank can and does provide the kind of politically disinterested, expertly prepared advice on the formulation of medium-term adjustment programs. And then, to use an old colloquialism, it puts its money where its mouth is. Recent World Bank lending has placed major emphasis on structural and sectoral reforms in the highly-indebted countries. In its fiscal year which ended June 30, 1986, its lending to the ten highly-indebted countries undertaking adjustment programs
increased by 47 percent over the previous year compared with a 16 percent growth in total World Bank lending. Fast disbursing adjustment lending comprised some 19 percent of total lending in fiscal 1986 and 37 percent of the lending program to middle-income countries. Adjustment lending comprised only 3 percent of total lending just five years ago. In short, the bank has shown that it can move quickly, and with purpose.

These are early days for assessing the results to date of the adjustment with growth strategy that was endorsed a year ago at the World Bank and IMF meetings in Seoul. There are, however, early signs that the strategy can yield results if the indebted countries press forward with their programs of reform, and if the more favorable external economic environment and financial support they require are forthcoming.

Therefore, I urge that this strategy be supported. However, this does not mean that we should dismiss out of hand alternative proposals for easing the debt crisis. We should examine them carefully. But I remain convinced that we should not press upon the indebted countries strategies that might appear to bring quick relief in the short-run but weaken their creditworthiness—and, thus, the commercial banks' willingness to remain their partners—in the long-run. These countries need external capital as well as export earnings to support their growth-oriented adjustment programs. With growth they can grow out of their indebtedness. Without growth their future is murky indeed.

I believe, therefore, that the broad outlines of preferred public policy are clear:

- We must strive for sustained economic growth in the industrial countries.
- We must work harder towards a more open trading system and resist protectionism.
- We must maintain an adequate flow of supporting capital to the indebted countries.
- We must support the international financial institutions that play the central roles in restoring growth and equilibrium to these countries.

But none of the above will have been worth an atom of effort if the indebted countries do not themselves press on with their adjustments and their policy reforms. Help begins at home! How committed they are will decide how successful the international cooperative effort to contain and then wind down the debt crisis is going to be. But those countries which are committed and have embarked on growth-oriented with adjustment programs deserve to be supported. Indeed they must be supported.