DETENTE SOLVES PROBLEMS FOR ALL THREE WORLDS

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The world economy, poised as it is on huge imbalances, could get a welcome boost from the current political climate of glasnost, perestroika and detente. The expected reduction in arms expenditure, not only by the United States also more generally in the developed, developing and socialist worlds, can free enormous amounts of funds for peaceful purposes.

The magnitude of the present imbalances, underlined by the US budget and current account deficits of roughly $ 150 billion a year each, the persistent surpluses of Japan and Germany taken together of a similar magnitude, and the combined debt of the higly indebted middle income developing countries of $ 370 billion, calls for urgent action. But as we have witnessed over the past several years, the current decision making processes are hard pressed to achieve even small corrections, not to speak of major shifts, like a substantial transfer of funds to the developing and socialist worlds.

A welcome catalyst now seems to be on the way in the form of grass-roots democracy movements in Eastern Europe and detente in East-West relations. Arms reduction developments are progressing at a remarkable speed to judge by the US Defence Secretary's recent unilateral initiative to reduce US defence expenditure by a total of $ 180 billion over a five year period implying an average annual reduction of $ 36 billion, while military blocks in Europe may re-trench much of their troops closer to home. There is intense speculation on the possible disarmament outcomes of the impending summit between Presidents Bush and Gorbachev.

The full economic implicatins need to be grasped. It has been estimated, that the NATO-related expenditure of the United States accounts for $ 150 billion or half of the total US defence budget of $ 300 billion. This would also imply that roughly one-half of the output capacity of the US arms industry (i.e. $ 60 billion out of about $ 120 billion) can be freed, in principle, to meet the Third World's unmet needs if the US commitment to NATO were relaxed. It would also free funds of the surplus countries, particularly of Japan, which are currently tied up in financing the US budget and payments deficits, to flow into developing countries to provide the necessary purchasing power. Likewise the reduction of military expenditures generally would also free funds in many other countries for development, including indebted countries in Eastern Europe and the Third World.

In fact, the present situation permits the linking of two problems which have not been looked at in an interconnected way but have been treated in watertight compartments. The first problem is that of maintaining or even accelerating economic growth in the developed world while correcting today's payments imbalances. The second problem is that of reducing the debt overhang of the highly-indebted developing countries and of attracting additional financial flows to them. This has involved, under the Brady Plan, debt reduction measures as the *quid pro quo* for domestic economic reform measures in these countries in the hope that, taken together, these steps will attract the additional resources needed by them to realise acceptable growth rates. Yet it is becoming increasingly clear that debt reduciton and policy reform alone may not be sufficient to achieve this objective in the absence of other supporting international measures.

To start with, consider the problem of maintaining adequate growth in the developed countries while correcting the large payments imbalances between them. it is now widely recognised that the United States cannot continue to run much further into debt without a crisis of confidence in the dollar precipitating it's free fall. This would leave the US with only the choice of substantially raising interest rates - and bringing about a world recession.

The difficulty with the US budget deficit so far has been that its reduction has posed politically painful choices, raising taxes or reducing social services expenditures with the

defence budget being taken as an immutable given. This is where detente becomes relevant, for the US commitment to NATO of $150 billion is roughly equal both to her budget defict and to her balance of payments deficit. If the US grasps the disarmament option provided by the current international climate she would be well placed to target for a reduction in her payments deficit in the range of $150-200 billion in order to achieve a modest surplus. However, a reduction of US import demand of this order would reduce demand for the rest of the world's exports by some 7.5%-10%, probably precipitating another gleval recession providing, that is, that correspondingly higher demand is not found elsewhere.

The conventional wisdom has it that the required demand expansion should come from the main surplus economies - Japan and Germany. However, neither of these countries appears likely to introduce major expansionary policies, possibly by no more than around $ 50 billion for both countries, and certainly not on the scale requred.

Recycling the surpluses to developing and socialist countries in support of economic policy reform then becomes the obvious counter to the deflationary impact of a reduction in the US deficit. A plan by the Helsinki-based World Institute for Development Economics Research - WIDER - published in 1987, called for making a beginning in this direction by recycling $25 billion a year from Japan, representing one-half of that country's current account surplus target, or $ 125 billion over a five-year period. According to Harvard Professor Jeffrey Sachs, this would improve the US trade balance by $ 10 billion annually, as compared with $ 2 billion resulting from a comparable programme of domestic expansion in Japan, making recycling five times as effective as equivalent domestic expansion.

A much greater recycling effort would be needed to offset in full the deflationary bias of the required US external deficit correction. The arithmetic development above suggests that the annual amounts to be recycled would need to build up to the range $ 100-150 billion, *pari passu* with the unwinding of the US deficit. In other words, a complex task of global macro economic co-ordination of the adjustment process is involved, so as to synchronise *ex ante* the stepping up of recycling with the winding down of the US deficit for world income and savings not to suffer.

This is the opportunity that needs ot be grasped. A preliminary estimate indicates a probable range $ 100-150 billion, for the net borrowing requirements of socially necessary growth in developing countries by the year 2000 (based on World Bank calculations assuming lower growth rates). By this is meant growth in the range 5.5% judged adequate to look after the attainment of minimum basic needs goals (in nutrition, access to health, education, water, sanitation and shelter), full employment objectives, and improved income distribution in developing countries as contrasted with 3.3% in the second half of the 1980s. Preliminary estimates by Massachusetts Institute of Technology Professor Lance Taylor, based on 17 WIDER country studies pursuing these goals, suggest that the additional net resource flows needed in 1990 alone to launch this process of growth are in the range of $ 80-100 billion. The rising scale of annual net resource transfers corresponding to these orders of magnitude during the decade 1990-2000 could be triggered by corresponding annual reductions in US military expenditure. The 1990 range of $ 80-100 billion is well below the current US commitment to NATO though more ambitious than the $ 36 billion annual reductions envisaged in the US Defence Secretary's initiative. These resource transfers would clearly serve to fill the corresponding deflationary gaps in the world economy that would arise from the phasing out of the US payments deficit. What would happen is that the world's excess savings would simply be switched progressively from financing an unproductive US budget deficit, provided mechanisms are developed for this, to help launch a new process of economic growth and structural change in the Third World.

The magnitudes indeed suggest that there is enough potential slack in the world economy, *given US adjustment,* to meet the external resource needs of both developing countries and reforming socialist economies for whom Marshall Plans are understandably very much in vogue. Indeed the problem may well be that the pace of US deficit correction in response to the rapid evolution of European detente may run ahead of the pace of policy reform in both developing and socialist countries needed to

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pean Community of the concept of a development bank for Eastern Europe constitutes a notable first step in this direction. The time for other new institutions of manageable size geared to Third World needs and environmental concerns on the scale of the Brandt Commission's World Development Fund may indeed have come.

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absorb effectively the substantial annual amounts of recycling involved. The Third World and the socialist world do not, on this scenario, have to compete with each other for a limited pool of world savings. There is more than enough room for both. If on the other hand the international adjustment process fails to work properly then the casualty will indeed be both world income and world savings, with the economy functioning well below capacity.

But recycling needs to be implemented effectively not only to gain the support of the donor community but also to avoid throwing good money after bad. Here, a recent proposal by Thorvald Stoltenberg, until recently Norway's Foreign Minister, is very relevant not only for the developing countries he had in mind, but also for the reforming socialist economies. He has proposed that conventional adjustment programmes be replaced with more comprehensive long term 'Development Contracts' which would guarantee the external financing of a country's development plan for achieving a minimum socially necessary growth rate up to the year 2000, and would also look after unforseen external shocks. The developing country, for it's part, would undertake to pursue appropriate domestic policies for improving production incentives of the kind required for gaining IMF and World Bank support, including maintenance of price stability, of appropriate exchange rates and the encouragement of private investment. There would also be a provision for bilateral grants from the donor community for basic needs purposes provided production incentives were set right so that countries are spared the customary socially and politically destabilising belt-tightening at the start of a fresh development effort.

In contrast, the case of my own country Sri Lanka illustrates the resource limitations of today's much more *ad hoc* international framework at its best, although domestic policy weakness cannot be ignored. The substantial balance of payments gain of the adjustment effort of the 1980's was virtually wiped out by unfavourable terms of trade although continuous co-operation was maintained with the IMF and the World Bank and a supportive Aid Group. The resulting real wage squeeze accompanied by the rapid growth of educated unemployed sparked off twin insurgencies in the Sinhalese and Tamil communities, paralysing the economy and reducing growth of around 1.5% in the last few years. If the employment problem alone were to be resolved over a five year period as warranted by socio political considerations then Sri Lanka would require to grow at around 7% a year, but if a ten year time horizon is allowed us we would be able to get by with annual growth of not much more than 5.5%. The problem is that time is running out rapidly for much of the Third World as ungovernable situation erupt in country after country in wake of the unfavourable adjustment experience of the 1980s, which Stoltenberg's proposal is designed to address.

Clearly we now also need a fresh approach to generate the funds required to alleviate problems in both the Third World and the reforming socialist world. Official development assistance (ODA) channelled through government budgets is currently $ 50 billion and has stabilised during the 1970s and 1980s at around 0.35% of the GNP of industrial countries, or at half the development assistance target of 0.7% of GNP. This has in effect meant that development aid grew only in line with the GNP growth of industrial countries, and even today's largest donor, Japan, is not planning to reach more than today's industrial country average ODA performance of 0.35% of GNP by 1992. Likewise, developed countries are likely to oppose ideas such as issuing SDRs or introducing an international tax for tackling the problem. Today's surpluses are essentially in the private sector, and are not available to government budgets without imposing significant burdens on taxpayers. Substantially increased budgetary appropriations for development aid are not therefore on the cards.

These surpluses can readily be tapped, however, under the collective guarantee of interested governments as happened for example when the World Bank was created with the guarantee element being contained in the Bank's callable capital. Government budgets would be only required to provide the fraction of capital paid in and interest subsidies required for concessional lending. Mobilising today's surpluses may well entail a fresh spurt of institution building in the 1990s to meet the substantial needs of protecting the global environment and of accelerating world development. The recent acceptance by the leaders of the Euro-

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