Business Cycles and Aid Cycles

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"Good times" can be as bad as "bad times". Or, rather: even more dangerous, since problems are more easily concealed.

The Swedish financial crash of the early 1990s, which may cost the taxpayers some 150-200 billion Swedish Kronor, or an amount corresponding to over ten times Sweden's annual aid budget, is largely the result of macroeconomic mismanagement during the apparently happy years of the late 1980s.

The market was no wiser than the government. The market expected real estate prices to increase for ever by some fifteen-twenty per cent per year. They didn't. In fact, real estate prices, and with them some commercial banks, have collapsed since 1991.

For the developing countries, a similar lesson can be drawn. Watch out for "good times".

The 1970s was an exceptionally favorable decade for many poor countries. Commodity prices were high, foreign aid was steadily increasing, and there was plenty of money to borrow. The real rate of interest was low, some years even negative.

The heavy borrowing was enthusiastically encouraged not only by the commercial banks, but also be the creditor countries' governments, and by the International Monetary Fund and the World Bank. The latter institutions consistently urged the developing countries to borrow more and more, and praised the efficiency of private capital markets. They also increased their own lending to developing countries.

In authoratitive publications, such as the World Bank's **World Development Report,** prospects for future borrowing were said to be excellent. For example, in the most pessimistic scenario about developing countries' access to foreign capital in the 1980s presented in the **World Development Report** of 1982, the rate of growth of net disbursements of credit to developing countries was estimated at 5,6 per cent per year. Wrong, again: lending actually fell drastically.

The optimism of the late 1970s had as little foundation as that of the Swedish commercial banks a decade later. And the "debt crisis" was not, as suggested by **World Development Report** as late as in 1983, a short-term liquidity problem.

Many developing countries have paid, and are still paying, a high price for their governments' irresponsible macroeconomic policies during the happy 1970s. We should not, however, forget that their major donors, creditors and advisors in the North, and the leading global financial institutions, both encouraged and financed the South's overborrowing and overspending. The behaviour of the major creditors was almost perfectly procyclical - during the "good times" of the 1970s credits expanded rapidly, only to be contracted when difficulties began.

Today, it is structural adjustment that matters. Fine - we all agree that sound macroeconomic management is preferable to unsound policies, and that undistorted prices are better than distorted ones.

But realism is still lacking. I have not yet seen a Policy Framework Paper, or an IMF report in connection with a structural adjustment programme, which does not display an optimistic bias. And the donors and creditors are still, I am afraid, playing an essentially procyclical role.

In developed countries, there are business cycles - in poor countries, aid and loan cycles.

The following pattern seems to be quite typical:

After a protracted balance of payments crisis, a structural adjustment agreement is signed with the IMF. The Paris Club provides some debt relief. The bilaterals contribute additional balance of payments support (and bail out the IMF and the World Bank by clearing the arrears to the "preferred creditors", who are unique in the sense that they never pay the price for their own mistakes).

Optimism is widespread. Export prospects are said to be good. The supply response from the private sector will result in an annual rate of economic growth of, say, 4.7 per cent during the period covered by the Policy Framework Paper.

In the name of providing "incentive goods", and to ease the social burden of adjustment, massive imports of consumer goods are financed with soft loans and grant aid. Thanks to the large inflow of dollars, the premium on dollars on the parallel market for foreign exchange virtually disappears. Domestic producers, however, complain bitterly about the shock suffered from import competition after trade liberalisation plus huge injections of foreign exchange.

The government of the adjusting country soon realises that the external gap has widened further. Imports soar, while exports remain depressed. Unemployment goes up. The foreign debt increases further, and more debt relief and balance of payments support will have to be asked for. The bilaterals, in particular the friendly Nordic countries, will, hopefully, foot the bill. For a while, at least.

After a year or two, "slippage" in the implementation of the programme is registered. The target for the fiscal deficit is exceeded by two percentage points. The IMF, and the donor community, begin to worry. The third tranche of the World Bank credit is not disbursed. Concessional aid flows are reduced.

Debt service payments have to be suspended. When the poor country really needs foreign exchange, the donor community refuses to provide it. And everybody seems to have forgotten who formulated the targets that were, from the very beginning, far too ambitious and optimistic to be reached in two or three years.

Bad times are here again. But it is really the "good times" that preceded the crisis that should be blamed.

The policy lesson from this little story is as straightforward as the lesson from the debt crisis ten years ago, or from the financial crash of today's Sweden: beware of "good times". Don't be procyclical. Whether you are a commercial banker or a foreign donor, you only make things worse by following the herd. Dare to go against the stream.

And think twice when respectable financial institutions make their optimistic forecasts about the future. They were wrong fifteen years ago, ten years ago, and five years ago - why on earth should they be right today?