FINANCE AND DEVELOPMENT

Kenya's New Breed of Tea Planter
The Multiplier Process
Financing Development in Pakistan
Trade and Exchange Policies for Economic Development
Balance of Payments Problems of Developing Countries
Economists, Engineers, and Development
IFC: An Expanded Role for Venture Capital

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THE FUND AND BANK REVIEW

FINANCE AND DEVELOPMENT

Volume IV Number 2 June 1967

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The author is Advisor on Planning Organization in the Development Services Department of the World Bank. He is also the author of *Planning in Pakistan, Planning in Yugoslavia, and Planning in Morocco,* and coauthor of *The Economic Development of Mexico.*

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Kenya’s New Breed of Tea Planter

Julian Grenfell

The name "Kenya" is derived from a Bantu word meaning "ostrich." To understand why this lovely country was named after this ungainly bird, you must gaze up at the grim and untidy peaks of Mount Kenya, rising 17,000 feet above the equator. The black rocks, capped year-round with snow, suggested to some early inhabitant the familiar color pattern of the ostrich’s plumage. So the mountain got its name from the ostrich, and the country got its name from the mountain.

Some of the melted snow that trickles down from Mount Kenya’s peaks through the thickly wooded lower slopes ends up at the bottom as the Mukengeria River. And since the beginning of 1964, a broad furrow has been channeling water from the river to irrigate a tea nursery at Kangaita, in the Kirinyaga District of Central Province. This nursery and one other, some 250 miles away at Kabianga in Kericho District, are among the largest tea nurseries in the world, and the seedlings reared there are the source of life of one of the most successful development programs under way anywhere in East Africa, the development of Kenya’s smallholder tea.
Tea Comes to Kenya

If the British had not taken up tea drinking as a national pastime, Kenya's tea program would probably not exist. They are the world's greatest tea drinkers; the 500 million pounds of tea that they consume each year constitute 30 per cent of the entire world consumption. In the days of Empire it was virtually standard procedure that where the British flag was planted, so was tea, if there was the remotest possibility of its growing there. Thus, at the beginning of this century, tea was planted for the first time in East Africa. It grew very well, but, until the mid-1920's, it was not planted commercially, and then internationally agreed restrictions kept expansion to a modest scale for the next 15 years. By the end of World War II the restrictions had lapsed, and commercial companies began rapidly to expand their acreages. There was anxiety that the expected increases in the tea output of some major Asian producers would lead to a glut, but these increases never materialized. At the same time world consumption continued on a steadily rising curve. For Kenya, with a wealth of land suitable for planting, this was a most propitious trend, and little time was wasted in taking advantage of it.

Commercial Growing

Today there are 60,000 acres of Kenya land planted with tea, and there are plans to increase this to 100,000 acres by 1970. Space presents no immediate problem, for Kenya's extensive virgin forest land has just the right sort of soil for growing tea—a medium loam with a good acid content and crammed with humus and plant food. So it seems that unless supplies are allowed to exceed demand, which is by no means impossible, there is little to prevent tea from becoming, possibly by the end of the 1970's, Kenya's prime export revenue earner. At present, coffee is still dominant, but its lead is becoming shaky. Sisal, for long the runner-up to coffee, is also in trouble. Sisal prices have been tumbling, and the rapid development in Europe and North America of polypropylene fiber from oil refinery waste gases spells out a most uncertain future. The outlook for tea, by contrast, is bright. Kenya's tea, like its coffee, is of the highest quality, and as long as the demand is there, it should command high prices. In 1950 the export of tea (going mostly to Britain) earned the equivalent of $3.6 million for Kenya; a decade later
it had risen to $12.3 million, and by 1965 it had reached $20.4 million and was still climbing.

Origins of Smallholding

Fifteen years ago, a profile of the Kenya tea industry could have been adequately compiled from the records of a handful of British tea companies. In the intervening years, however, the pattern of the industry has been changing. While the large commercial tea estates still produce the bulk of Kenya’s tea, the number of African smallholders engaged in growing tea has been increasing steadily. Six years ago, smallholders accounted for only 6 per cent of the acreage under tea. Today they account for 23 per cent and will soon account for more.
At Gaikuyu, a woman plucks the top leaves: great care in all operations has been basic to the success of the project.

The development of smallholder tea cultivation is, of course, only one feature, though an outstandingly successful one, of the general development of African agriculture in Kenya since World War II. It has to be remembered that, before the War, agricultural development had been pretty well confined to those areas of Kenya, known as the “scheduled areas,” which were reserved for the European farmers. Farming on these 7.2 million acres of select land (much of which has since been resettled by Africans) was on a commercial scale and generally blessed with handsome profitability.

But the Africans farming the 33 million acres of the “nonscheduled areas” were, with very few exceptions, outside the money economy. Whatever crops and livestock they reared, they reared for the single purpose of subsistence. The standard of living of these subsistence farmers could not be raised unless and until they were introduced to commercial farming.

Obstacles in the way of achieving such an objective were formidable. For one thing, Africans had for generations felt no incentive to produce anything in excess of what they and
Kamarihitha, Central Province, is one of the many new villages built in the tea-growing districts during the Mau Mau Emergency.

their families needed. They would not easily be persuaded to put in extra work for the purpose of marketing a surplus. There were backward agricultural practices to be eradicated and more efficient methods taught.

Land Reform

But perhaps the most serious and basic problem was the chaotic distribution of land under the traditional tribal systems of land tenure. It is true that, in some areas, there was de facto individual ownership of land, and in a number of places coffee and later tea cultivation by Africans was getting under way. Roger Swynnerton, the colonial administration’s Assistant Director of Agriculture who was the chief architect of African agricultural development in Kenya during the early 1950’s (his original plan forms the basis of almost everything done since), was convinced that until something positive was done about land reform, little, if anything, could be done about widespread agricultural improvement. Orderly development was very much an uphill task as long as the African farm land was so extensively subdivided among families and individuals, scattered all over the place, and with nothing meaningfully inscribed anywhere as to who owned what. In areas where population pressures were particularly severe, the ingeniously
Soil suitable for tea cultivation in Central Province is tilled by men and women of the Kikuyu tribe.

confusing traditional laws of tenure seemed to produce as much litigation over the land as cultivation on it. The obvious first step, then, was the systematic consolidation and registration of the holdings.

While reforms of this sort had for some time been urged and encouraged by local agricultural officers, and here and there they had been voluntarily initiated, it took the Mau Mau uprising, itself largely a product of the
frustrations of the landless Kikuyu, to set the wheels of government action turning. Ironically enough, the uprising made the task easier in some important respects. By the time the Government launched its program of land reform in 1955, nearly all of those Kikuyu leaders who might have put every obstacle in the way of dismantling the ancient tribal system of land tenure were in detention centers. But that was not all. Military operations against the Mau Mau had made it necessary, for reasons of public safety, and not least for the safety of the Kikuyu farmers themselves, to gather the Kikuyu off their scattered individual plots and settle them, temporarily at least, in specially erected villages. This, of course, made it that much easier to sort out the nightmarish jigsaw of land holdings. Thus, while the campaign against the Mau Mau continued, the Government took advantage of what it quaintly but not altogether inaccurately described as the "favorable climate" to launch the much-needed program of reform.

Today, the land on which the smallholders are growing tea as owner-occupiers is land consolidated under Swynnerton's plan. But the earliest experiments in smallholder tea cultivation predate the launching of the land reform program. At the beginning of the 1950's, pilot projects were initiated in Nyeri, one of the three Kikuyu districts, and in Kericho, an area famed for its large commercial tea estates. By the mid-1950's, the Department of Agriculture was convinced that African smallholders could not only grow tea, but tea of a definitely superior quality. To many people, even knowledgeable people, this came as a surprise; only a few had believed that local people could make a success of a venture so far removed from traditional farming. Success did not come without trouble. The Department did, in fact, at one point try to get a group of African farmers to grow tea on centralized blocs of pooled land. This was a failure, mostly because the farmers could summon up no enthusiasm for growing tea on land which they neither owned nor occupied.

Smallholdings Spread

As the work of land consolidation and registration progressed, tea planting in areas that were ecologically suitable became increasingly popular. By 1957 a government-financed tea factory had been opened at Ragati to process green leaf grown by the Nyeri smallholders, and in 1959 the Government asked the then Colonial Development Corporation (an organ of the U.K. Government) and various commercial companies to consider the over-all processing requirements for smallholder tea with a view to their investment in factories. A representative mission took a hard look at the situation and came to the conclusion that smallholder tea growing must be put on an organizational footing that would permit long-term integrated development planning and attract long-term finance. Thus, in the autumn of 1960, following further more detailed studies and recommendations, the Special Crops Development Authority was set up to take over responsibility for all smallholder tea development. In 1964 the Authority was reconstituted and renamed the Kenya Tea Development Authority (KTDA), logically enough, since the SCDA, totally preoccupied with the rapid development of smallholder tea, had never actually got around to developing any other special crops.
In promoting and fostering the development of Kenya's smallholder tea, the KTDA performs three principal functions. First, it establishes and finances the tea nurseries that supply the planting material to the smallholders, either for cash or on credit, and it supervises the eventual planting and cultivation. Second, it establishes buying centers for green leaf and provides staff and transport to collect, inspect, and carry the leaf to the factories. Third, it arranges for the processing of the smallholders' leaf in existing factories or new ones, and participates in the financing of them. The Authority’s development program is based on two Plans, each Plan being built around an agreed planting program based on the assessed needs and demands for planting in each tea growing district. The First Plan provided for the planting of 11,100 acres of tea and the construction of six factories. Planting began in 1959 (under the old SCDA) and is now complete. All six factories are already in operation. The Second Plan provides for the planting of a further 14,400 acres and the construction of ten more factories. Planting under this Plan began in 1963 and will be completed in 1968/69.

These Plans have called for some hefty investment. For the field development under the First Plan, the Colonial Development Corporation (CDC; now the Commonwealth Development Corporation) agreed to lend £900,000 and the Kenya Government £20,000. Subsequently, Germany, through the agency of the Kreditanstalt fur Wiederaufbau, lent £212,000. The financing of the six factories was carried out in each instance as a joint enterprise, two thirds of the cost being met by the CDC and the remaining third by one or more of the established commercial tea companies. The CDC is once again putting up money for the field sector of the Second Plan, and the KTDA is providing a good sum out of its own revenues. But the greater part, the equivalent of $2.8 million, is being lent by the International Development Association in the form of a 50-year interest-free loan to the Kenya Government for relending at commercial rates to the KTDA. These funds have been provided to the Authority for nursery development, including expenditure on seed (mostly from neighboring Tanzania), field supervision, and for the costs of inspection and collection of leaf, including salaries and wages and the purchase of vehicles and equipment. The factories, like those of the First Plan, are to be financed jointly by the CDC and the commercial companies, but this time the Kenya Government will also be involved to the extent of putting up one sixth of the required capital. So much for finance.

How Smallholding Works

On the slopes of Mount Kenya, where the tea bushes are spread out like the green baize tops of a thousand billiard tables, it all seems a long way from the flashing cameras and the scratching pen nibs, the handshakes and the homilies which mark the moment when the bankers and the officials breathe life into what will be a very human, very close-to-the-earth venture.

And yet the smallholders, on their small patches of land, are aware of being involved in something of importance, something of value. It was the Minister for Agriculture himself who laid the foundation stone of the Kangaita Factory; the Minister for Economic Planning
and Development came up from Nairobi to open the completed factory and to tell them that the high quality of their tea and other cash crops was proof that they were now fully prepared to enter into the modern sector. The President himself, Mzee Jomo Kenyatta, came to visit the nursery and the factory and to talk with the local people about the great opportunity they now had to better themselves and help their country.

Such high-level encouragement is effective. More and more farmers want to join the KTDA’s schemes, and the Government and the KTDA would be delighted to see them do so. But smallholder tea growing, like all development projects, has its problems, even if they are surmountable.

Take a typical smallholder in the Kirinyaga District. He has been established on his three and a half acres of consolidated land for a number of years now. He is fortunate in that his holding is situated within the “tea line,” that is to say, within the area demarcated as being suitable for tea growing, and outside of which it is not permitted. Five years ago he was a subsistence farmer, growing maize, beans, and potatoes. He still grows these, but on three acres only. Today he has just over half an acre of his land planted with tea, which this year will earn him about £25 net. Without having to employ outside labor, he and his family could manage a whole acre of tea which, when fully mature at six years, could earn him £90 per year. The Authority is sympathetic to such ambitions, but so many farmers have applied to join the ranks of the tea growers that there isn’t enough planting material at present to go around, and many must wait for the next planting program.

Up the red dusty road, at the Kangaita tea nursery, they are rearing the seedlings which will be sold as tea stumps to the smallholders. Over the best part of 400 acres, the southeastern slopes of Mount Kenya have been shorn of the dense forest growth with a geometrical precision and neatness suggestive of some giant barber’s artistry. But it was scarcely as simple as that. At one point torrential rains brought all progress on the nursery to a month-long standstill as flood waters washed over the newly prepared ground and marooned the heavy tractors in a glutinous sea of mud. And then out of the forest came the elephants; herds of them, trampling over the carefully constructed irrigation channel. Today an electric fence encircling the nursery discourages such incursions.

When the nursery is expanded to its full 400 acres, it will be twice the size of the biggest tea nursery anywhere in the world and will be producing enough stumps to satisfy the demand of all growers on the east side of the Rift Valley. Everybody knows that the number of smallholders is going to increase. They know it at the tea factory across the road from the nursery. When this was constructed as a joint enterprise by the CDC, the KTDA, the Government, and a commercial partner, George Williamson Africa Ltd., it was built with extra space to allow installation of more machinery whenever the increase in the volume of leaf calls for it. The factory manager is much impressed by the quality of the leaf that comes up to his factory. He does a first-rate processing job, but he needs good leaf to work with, and that is what he consistently gets from the 1,400 acres of smallholder tea in Kirinyaga District and another 450 acres in Embu Dis-
strict. Trial production began at the factory at the beginning of November 1965. By March of the following year the first export sales had been made in London, and by the end of April sales had arrived at the top of the market for African teas.

The smallholder down the road with his half acre of tea sends his leaf to the factory at Kangaita. He brings it on the appointed day to the local buying center, about a mile from his holding. The center, established and operated by the KTDA, is a small open-sided barn furnished with trestle tables and set just off the road. There, with a group of fellow growers, he awaits the KTDA truck which will set down at the center a leaf inspector, a buying clerk, and a pile of steel wire baskets. Having made its brief stop, the truck moves on to the next center on its chosen route, and will return in the afternoon to collect the inspector, the clerk, and the full baskets. At the center, the business gets under way, beginning with the inspection of the leaf. Two leaves and a bud snapped off the top of each tea shoot; that’s what the inspector is looking for, and that’s all he will buy. Our friend and his family have done their plucking with skill; there is little for the inspector to reject. The leaves are weighed and the clerk marks down the sale—at 40 Kenya cents a pound. No money changes hands, however. The KTDA office maintains an account for each individual grower. This smallholder, like an increasing number of his colleagues, has a bank account, and at the end of the month a check will be paid into it. The sum represents 40 cents for each pound he sold, less 10 cents a pound retained by the Authority for operating costs and a further 7 cents a pound deducted as monthly recovery of its material investment in the smallholding. This latter levy ceases when the assessment on that particular smallholding is paid off. But this is not the final payment to the smallholder for his tea. Based on the profits made by the factories, the Authority will make him a year-end “second payment” of maybe 15 or more cents a pound, thereby enabling him to make up most if not all of the deductions.

Meanwhile, the truck has returned for the leaf. Kenya tea collection roads are not ranked among the world’s marvels of engineering. They are adequate, that is all. The traffic on them is very light, and four-wheel drive pretty well dispenses with the need for surfacing, except where the drainage is known to be bad and where the gradient is unusually steep. But when the rain comes down really hard and the collection trucks have plowed a sticky furrow back to the factories, getting stuck with a load of tea is no joke. If leaf is not processed within about six hours of plucking, it deteriorates and is useless. This happened to 2,000 pounds of leaf in Kirinyaga District not so long ago.

With the help of some $3 million from the International Development Association, about 900 miles of tea collection and factory access roads are being constructed in the various tea-growing areas of Kenya, and some 15 small road maintenance units are being established and equipped. The collection roads are being built to very modest standards, but the factory access roads, where the traffic is much heavier, are all being gravel surfaced. Leaf collection will remain a rather risky business in the wet weather until a general upgrading of the standard of collection roads can be afforded.
and the building of new factories has cut down delivery distances.

Problems aside (though not ignored), what is going on around the slopes of Mount Kenya, and elsewhere where the African tea growers have taken root, generates an abundance of good that defies quantification. The assessment of success is often as much a matter of sensing a changed atmosphere, detecting a surging spirit, as it is of totting up a column of figures. Not that the smallholder tea growers are without some eminently measurable indicators of rising living standards. It’s just that the pride which they show in what they and the KTDA are achieving in the face of a fair share of problems makes one optimistic that the future will be fruitful after such promising beginnings.
What does it really mean?

The Multiplier Process

In the discussion of economic questions, even in the nonspecialist press, many terms are used which until quite recently were employed only by economists or others professionally concerned. This series of articles is designed to explain the economists' shorthand.

Shu-Chin Yang

The concept of the multiplier process was first introduced into economic thought in discussions of unemployment and business cycles in industrialized countries. It has become one of the pillars of modern Keynesian economics.

It is easy to understand that an increase in investment will cause income to expand, while a decrease in investment will cause it to contract, because investment is just one part of the national income. But if we think in terms of economic dynamics, the story does not end there. An increase in investment will initiate a process by which income will eventually increase by an amount greater than the original increase in investment.
The Multiplier Process

Shu-Chin Yang joined the Economic Development Institute of the World Bank in 1963. Previously he was head of the Economic Survey Branch of the Secretariat of the Economic Commission for Asia and the Far East in Bangkok, Thailand. Mr. Yang received his doctorate in economics from the University of Wisconsin and is the author of *A Multiple Exchange Rate System: An Appraisal of Thailand's Experience, 1946-1956.*

**The Process**

The multiplier process is a chain reaction. Suppose Mr. A decides to build a workshop and engages a building contractor, Mr. B, to do it for him. Mr. B receives from Mr. A, as the total payment for the job, the sum of $10,000. Out of the $10,000, suppose Mr. B makes a profit of $1,500; the rest he uses for paying the laborers he hires and for the building materials he buys. Mr. B will spend some of this additional income, but he will probably save a part too. The construction laborers and the wholesalers of building materials will do likewise—they will spend a part of their additional income and save the balance.

Note the impact of Mr. A’s investment upon national income and expenditures. When Mr. A gave Mr. B a check for $10,000 for a new workshop, there was an initial increase of that amount in society’s stream of income and expenditures. Furthermore, when Mr. B and his fellow laborers and merchants spend some of their income earned in the course of building Mr. A’s workshop, there will be an additional increase in income and expenditures. A further increase will follow in the next round, as Mr. C and others who sold materials and services to Mr. B will in turn spend some of their new income. This process will go on and on adding a smaller and smaller amount of income to the national income stream in each succeeding round.

The rate of increase in income declines in each round, because people will presumably always save a portion of their additional income, spending only a part. If people save only a small part of their income, spending the greater portion of it, clearly people in the following round will earn a greater income. Economists call the proportional factor which shows the portion of additional income that people tend to consume the “marginal propensity to consume.” The greater the marginal propensity to consume, the greater will be the induced income and expenditures out of the same initial investment.

Assuming that people save one fifth of their incomes and spend the rest—i.e., that the marginal propensity to consume is four fifths—we get a spending chain as shown on the following page.

In the first five periods after the initial investment, the total increase in national income will be $33,616. But eventually—as can be demonstrated mathematically—it will be $50,000.
Thus far the description is of a very simple economy, without taxation, for example. But of course the multiplier effect of government activities is very important. Government expenditure, taken by itself and assuming no changes in taxation (and also no offsetting decline in private investment), has a multiplier effect upon income just like that of private investment. A chain of responding can be set into motion by public road building, government engagement of additional teachers, and so on, just as effectively as by private investment in building a new workshop.

It might seem that a tax reduction which adds disposable income to the private sector would have the same effect on the amount of national product as government expenditures. But this is not so. Government expenditures add initially and immediately to the demand for goods and services, and subsequently to induced consumption, while tax reduction does not have the same initial impact. Government expenditures are a part of—and hence have a direct influence on—aggregate demand. But tax reduction in effect omits the first round; it has an indirect influence on aggregate demand, making its impact by increasing the volume of consumption expenditures (to a lesser extent it may also affect investment expenditures as well). A tax reduction of $10,000 adds the same amount to the country’s disposable income, but the persons receiving this amount would not spend the whole of this, for they tend to save a part of it.

Suppose a government expenditure of $10,000 brought about an eventual increase in incomes totaling $40,000. We know that the increase of $40,000 may be divided into two

### A Typical Spending Chain

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The Multiplier Process

parts: $10,000 spent for government goods and services, and $30,000 spent subsequently on consumption. A tax reduction of $10,000 would bring about an eventual increase of consumption of $30,000. It would lack the initial effect of generating $10,000 of income that the government expenditure had. Because of the inclusion of the original $10,000 in the government expenditure multiplier, the multiplier will always be greater than the tax reduction multiplier by one, to reflect the original sum of investment expenditure. Similarly, working toward the contraction, the tax increase multiplier will have a smaller effect than the expenditure reduction multiplier.

This divergence between the expenditure multiplier and the tax multiplier leads to an important aspect of fiscal policy, which common sense observation often fails to grasp. Frequently it is contended that balancing a budget, in the sense that every change in government spending is matched by a corresponding change in taxes, will wipe out the potential inflationary pressure created by government spending. Such an argument would be valid only if the “negative” effect of taxation is wholly offset by the “positive” effect of expenditure. But it has been seen that the expenditure multiplier is always greater than the tax multiplier by one. Even if the government expenditure is solely financed by taxes, the national income and expenditures will eventually increase by the original sum of increase in government spending.

Balance of Payments

New exports also have exactly the same multiplier effects as does new domestic investment. They raise incomes directly, but in addition they set up a chain of further spending and respending. A million dollars of new orders of rubber to Malaysian rubber wholesalers will create $1 million of primary jobs and income. Workers and owners of rubber estates as well as rubber wholesalers in Malaysia will in turn spend a large portion of their additional incomes on food, clothing, and other things. Ultimately, the secondary incomes so propagated will be several times the original new export orders.

Malaysia also imports goods and services from foreign countries. No matter how the increase in domestic purchasing power is originated (either through an increase in private investment in shoe-manufacturing or through an increase in government road-building activity, or through an increase in rubber exports), some parts of the chain increases in incomes are likely to be spent and respent on imported commodities. At each step such expenditure abroad acts as “leakage” and does not generate further domestic purchasing power. To think of the multiplier process in terms of leakages is one way of understanding it.

Change in Consumption

Thus far we have assumed that a change in private consumption bears a fixed proportion to a change in the national income and that the initial economic change comes through either a change in private investment, in government expenditure, or in export. For it is believed and has been observed that generally a change in private consumption in association with a given change in national income is fairly stable.
However, the propensity of any economy to consume can change either abruptly or through time. For instance, in industrialized countries it is sometimes found that consumer spending on durable goods, such as automobiles, does change independently of income change. (This
time by the influence of the consumption patterns in richer countries. Any increase in private consumption independent of an increase in income will have a double effect on the subsequent increases in income because it raises the initial injection of expenditure as well as enlarging the multiplier itself.

**An Illustration**

There are three ways in which new income received may leak out of the system being subjected to the multiplier process. It may be spent on imported goods, paid out in taxes, or saved. If it does not leak in any of those ways it may be spent on domestic consumption goods and services. The latter expenditure, sooner or later, creates additional income.

We can then think of the effects taking place in a series of "rounds" with intervals of time between them. In each round there are the three types of leakages from the stream of income and expenditure on domestic consumption goods which create the new income available for the subsequent round.

Now, let us assume higher export earnings by a whole group of farmers, the increase in this case being 500 units. Suppose further that the proportions in which this income is disposed of are as follows:

- Proportion spent on domestic consumption goods: 60%
- Proportion spent on imported goods: 20%
- Proportion paid out in taxes: 10%
- Proportion saved: 10%

On these assumptions the disposition of the additional income in the first instance is set out...
on the first line of Table 2 under the heading “1st round.” Of the total amount, 60 per cent, i.e., 300 units, was spent on domestic consumption goods and therefore becomes a new source of income available for a “second round” of expenditure. (We assume that the government does not spend the additional tax revenue and that the private sector does not invest more.)

If we assume the same proportions as before, the second line shows what happens in the second round. If we suppose that the same process with the same proportions goes on round after round, we find that at the end of five rounds the totals at the bottom of each column are more than twice the figures for the first round. In fact, if we went on indefinitely with similar figures we would approach closer and closer to a proportion of two and a half times the first round figure. This proportion between the hypothetical total and the figures in the first round, which in this case is 2.5, is the multiplier.

We may note further that the ultimate total of taxes (125), savings (125), and imports (250) equals 500, the amount of the additional income that started the process. This, as we have seen, is no accident. These are the leakages out of the flow of new income on each round, which eventually reduce the flow to zero, so that the economy reaches equilibrium. The cumulative leakages must, therefore, be such that the injection of foreign, eventually equal the initial injection of spending cannot permanently lift the economy above its previous level. To achieve a permanent or sustained forward push there must be a continuous new injection, at a steady rate, if not from the same source then from one or more of the other active factors: investment, government expenditure, and exports.

### Table 2

<table>
<thead>
<tr>
<th>Private Income</th>
<th>Expenditure on Domestic Consumption Goods</th>
<th>Imports</th>
<th>Taxes</th>
<th>Savings</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st round</td>
<td>500</td>
<td>300</td>
<td>100</td>
<td>50</td>
</tr>
<tr>
<td>2nd round</td>
<td>300</td>
<td>180</td>
<td>60</td>
<td>30</td>
</tr>
<tr>
<td>3rd round</td>
<td>180</td>
<td>108</td>
<td>36</td>
<td>18</td>
</tr>
<tr>
<td>4th round</td>
<td>108</td>
<td>64.8</td>
<td>21.6</td>
<td>10.8</td>
</tr>
<tr>
<td>5th round</td>
<td>64.8</td>
<td>38.88</td>
<td>12.96</td>
<td>6.48</td>
</tr>
<tr>
<td>Total rounds</td>
<td></td>
<td>691.68</td>
<td>230.56</td>
<td>115.28</td>
</tr>
<tr>
<td>Ultimate total</td>
<td></td>
<td>1,250</td>
<td>750</td>
<td>250</td>
</tr>
</tbody>
</table>

\[
\text{Multiplier} = 1 \div \left( 1 - \frac{60}{100} \right)
\]

or

\[
1 \div \left( \frac{20}{100} + \frac{10}{100} + \frac{10}{100} \right) = 2.5
\]

### Employment and Capacity

The importance of the multiplier process in modern economic thinking derives from the characteristics of economic depression in industrialized countries, where there coexist large numbers of unemployed workers on the one hand and substantial excess productive capacity (in transport equipment, machinery, factory buildings, etc.) on the other. What is lacking is effective demand. Thus an increase in investment expenditure, provided it is a net increase for the public and private sectors taken together, will quickly set off a chain expansion of effective demand for goods and services. Such a multiplier process will immediately draw formerly unemployed laborers to work on the formerly unused productive capacity,
and it is very easy to produce more goods to meet the increased demand. The result is simultaneous increases in both money income and real output. In a capitalist economy, the most important dynamic factor in increasing effective demand is private investment. But during a depression new incentives are needed for private businesses to increase investment, and this is why many economists nowadays favor a resort to public investment to generate the new incomes and expenditures needed to cure depression.

Money Income Versus Real Output

The effectiveness of the multiplier in increasing real output depends on the level of unemployment and the degree of utilization of capacity. The distinction between “money” and “real” effects is very important. It may be argued that, since in developing countries there are large numbers of unemployed and underemployed labor, and since investment multiplies income, it would be easy for such a country to raise its national income simply by increasing investment spending. The basic fallacy in this argument is that it overlooks one of the fundamental obstacles to economic growth of less developed countries, namely, the shortage of real capital or productive capacity. Since productive capacity is limited in these countries, a less developed economy will, if money income and expenditure keep increasing, soon be using all of this capacity. In the developed countries, where productive capacity is abundant and can be readily expanded, the effective limit to increases in real output over periods of a few months or a few years is generally set by the numbers available for employment. Output will cease to grow when everyone of working age who is able to work and wants to have a job has one. In developing countries, where capital is scarce, the limit is usually reached when productive capacity is fully utilized. It is true that in either type of country an increase in investment will in due course lead to an expansion in productive capacity. But during the gestation period, an excessive injection of investment expenditure will only expand money incomes and raise prices.

Once the limit to an increase in output has been reached (whether this is set by full employment or by full utilization of productive capacity), any attempt to increase investment still further will set up a situation where prices will tend to rise. Money income will still increase, as indicated by the multiplier, but real output will not. When real output and income are not increasing, there will also be no increase in real saving to finance real investment. Thus the real multiplier becomes nil. But the money income will still multiply, providing that investment expenditure is still increasing. In this way the money multiplier diverges from the real multiplier.

The Elasticity of Supply

While the lack of capital goods industries in developing countries makes it particularly difficult for them to create more productive capacity for industry, the problem of securing speedy increases in agricultural output may be even more serious and deep-rooted. The number of employees hired for wages is comparatively small; the vast majority of cultivators are self-employed or family-employed. A good part of the national output, especially of food, is produced not for the market but for consumption at home. An increase in cultiva-
tors' incomes above the bare subsistence level may lead them to consume more themselves and leave less to be marketed. Or, owing to high rents or for psychological reasons, they may even prefer more leisure to higher output. The result may be a reduction in market supplies.

Agricultural output in developing countries is also very difficult to increase quickly because of persistent production bottlenecks, such as a lack of irrigation facilities or inadequate technical training, which take a long time to correct. Thus, in the short run, agricultural output depends very much on the weather.

It is true that in most developing countries, many people in the rural areas are underemployed. But, since the surplus laborers have to be trained before they can be put on other jobs, a simple injection of purchasing power cannot mobilize such labor into productive employment. Such training requires time, effort, and money, and even when they are trained, the workers have to be moved into the towns where industries are located.

The low elasticity of supply in developing countries sets a sharp limit to the effects that the multiplier process has in them. They are not at all in the same position as developed countries during a depression. In developing countries a simple increase of purchasing power cannot generate a prolonged increase in output but is apt to lead only to a quick rise in prices.

Here lies the limitation of “deficit financing” of economic development. In developing economies the real problems are how to increase productive capacity and how to produce goods more efficiently. The injection of money, by itself, is no substitute for the fundamental task of development, the task of increasing society's capacity to produce. The achievement of this task is a long-run effort that involves not only increases in saving and investment but, equally, an increase in human skills, changes in human motivations, improvements in organizational arrangements, and the development of new institutions. It is this complex web of human and physical factors which, in combination, generates economic development.
Financing Development in Pakistan

Pakistan’s achievements under its Second Five-Year Plan ending in June 1965 have made the country an outstanding example of how planning economic development programs and executing them should be carried out. The credit for this should go to those parties who cooperated to attain the targets of the Plan: to the Pakistani people themselves, to the Government, and to many foreign governments, international agencies, and individuals.

M. Mostafa Hassanein

When Pakistan entered upon its Second Five-Year Plan in June 1960, it was laboring under the usual handicaps of developing countries: extreme poverty, lack of trained technicians, and shortage of capital. It also had a unique handicap—that of administering two major regions 1,000 miles apart. In spite of these handicaps, which, of course, even now it has not thrown off, Pakistan was able to pick up speed in the development race. The gross nation product (GNP), at constant prices, increased at an annual rate of 5.5 per cent. Per capita income increased at a rate of 2.8 per cent per annum in contrast to the preceding five years which showed hardly any increase.

One of the most important features of this development was its even spread. All sectors of the economy, including agriculture, shared in and contributed to it. Under earlier plans, the agricultural community, which is the backbone of Pakistani society, had been neglected. In the 1950’s, agricultural output increased by an annual average of only 1.3 per cent; during the Second Plan period (July 1, 1960 to June 30, 1965) the rate was 3.4 per cent. This success in agriculture was mostly a result of the policies pursued by the authorities. The prices of basic agricultural products were maintained at realistic levels and many imports, such as fertilizers and pesticides, were made available at subsi-

The Korangi Refinery, West Pakistan: “Private capital was assured of continuing growth and profit.”
The farmers were encouraged to use reliable tubewell irrigation and follow better farming practices. The new growth in agriculture was a conspicuous success, and it was particularly important because it was making up for lost time. The relative growth in agriculture was still the lowest among all sectors of the economy.

**Second Plan Growth**

<table>
<thead>
<tr>
<th>Sector</th>
<th>Percentage of Growth During Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construction</td>
<td>195.1</td>
</tr>
<tr>
<td>Manufacturing and Mining</td>
<td>61.4</td>
</tr>
<tr>
<td>Transport and Trade</td>
<td>36.4</td>
</tr>
<tr>
<td>Other services</td>
<td>26.4</td>
</tr>
<tr>
<td>Agriculture</td>
<td>18.0</td>
</tr>
<tr>
<td>Total GNP</td>
<td>30.4</td>
</tr>
</tbody>
</table>

"The high rate of growth in Pakistan involved, of course, a great outpouring of investment expenditures." Here a worker adjusts equipment in the Korangi Refinery.

**Investment and Saving**

The high rate of economic growth in Pakistan involved, of course, a great outpouring of investment expenditures: PRs 32,150 million during the Second Plan period on fixed assets and stock formation. Investment expenditure grew at an average annual rate of 21 per cent over the five-year period.

This great volume of investment expenditures was financed by means of greater domestic saving and the utilization of external resources. Domestic savings increased from 6.5 per cent of GNP in 1959/60 to 10.5 per cent in 1964/65. Marginal saving (i.e., saving from additional income) was about 19 per cent on the average during the Second Plan period. The following table gives a fuller picture of the
items mentioned during the last years of the First and Second Plans.

**Investment and Savings**

*(In millions of Pakistani Rupees)*

<table>
<thead>
<tr>
<th></th>
<th>1959/60</th>
<th>1964/65</th>
<th>Percentage increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>GNP (market prices)</td>
<td>32,679</td>
<td>48,291</td>
<td>47.8</td>
</tr>
<tr>
<td>Total investment</td>
<td>3,160</td>
<td>8,330</td>
<td>163.6</td>
</tr>
<tr>
<td>Gross domestic savings</td>
<td>2,130</td>
<td>5,077</td>
<td>138.4</td>
</tr>
<tr>
<td>In per cent of GNP</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment</td>
<td>9.7</td>
<td>17.3</td>
<td>78.4</td>
</tr>
<tr>
<td>Savings</td>
<td>6.5</td>
<td>10.5</td>
<td>61.5</td>
</tr>
</tbody>
</table>

**Government Outlay and Sources of Finance**

At the same time that investment was rising in this way, its character was changing; there was a distinct tendency for the relative share of the public sector in investment to decline and for that of the private sector to rise. The public sector was responsible for 60 per cent of total investments at the end of the First Plan (it ran from July 1, 1955 to June 30, 1960), but for only 52 per cent by the end of the Second Plan. A basic cause for the decline in the government sector's relative share in the total development effort was that project aid and loans, in particular, fell short of expectations by as much as 52 per cent. One reason for the shortfall in foreign resources was that planners did not adequately allow for the difference between commitments and disbursements. On the other hand, as will be seen when the balance of payments is discussed in this article, because of the success of the export drive and the saving in foreign exchange expenditures, the need for foreign resources was not as great as expected.

The increase in domestic resources over
"The private sector invested in development nearly two thirds again as much as was expected."

those that had been planned for the government sector amounted to PRs 1,854 million or 35 per cent, while the excess in revenue surplus was about 9 per cent. Some of the Government's success in adding to its domestic resources was due to determined efforts to streamline the taxation machinery and to increase revenue. But above all, it was the general rise in economic activity that was decisive in increasing government revenue. To Pakistan, as to other countries in a similar stage of economic development, this rise in government revenue was vital not only for development, but for helping to meet rapidly expanding demands elsewhere. It was needed, for example, to meet higher salaries for government employees, higher defense costs, and much greater charges to service the public debt. In fact, the increase in government revenue was enough to cope with much higher nondevelopment expenditures and at the same time to result in a surplus.

In addition to the above fiscal efforts resulting in the increase in the domestic resources at the disposal of the Government, there also was an increase of about PRs 395 million, or 24.7 per cent, in net capital receipts over the Plan's projection. Despite the increased resources, the Government had to rely on the central bank for PRs 1,135 million to finance the Plan. The following table gives an account of financing the government sector's development expenditures comparing the estimated actuals with the Plan's targets.

The Private Sector's Development Effort

Although the Government's contribution was striking, the private sector's development effort during the Second Plan period was even more so. Statistics here are not plentiful, but they suggest that the private sector invested in development nearly two thirds again as much as was expected. Most of this came from domestic private savings. The other components were loans in foreign exchange (PRs 1,466 million) and foreign private investment (PRs 451 million)—both much lower than expected.

The main factors behind the success
Financing Government Development Expenditures
Under the Second Plan
(In millions of Pakistani Rupees)

<table>
<thead>
<tr>
<th></th>
<th>Plan Target</th>
<th>Estimated Receipts</th>
<th>Percentage Deviation from Target</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Domestic Resources</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue surplus</td>
<td>3,670</td>
<td>3,994</td>
<td>+8.8</td>
</tr>
<tr>
<td>Net capital receipts</td>
<td>1,600</td>
<td>1,995</td>
<td>+24.7</td>
</tr>
<tr>
<td>Borrowing from banking system</td>
<td>—</td>
<td>1,135</td>
<td>—</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td>5,270</td>
<td>7,124</td>
<td>+35.2</td>
</tr>
<tr>
<td><strong>2. Foreign Resources</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commodity aid</td>
<td>3,500</td>
<td>3,090</td>
<td>-11.7</td>
</tr>
<tr>
<td>P.L. 480 counterpart funds</td>
<td>600</td>
<td>1,194</td>
<td>+99.0</td>
</tr>
<tr>
<td>Project aid and loans</td>
<td>5,250</td>
<td>2,542</td>
<td>-51.6</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td>9,350</td>
<td>6,826</td>
<td>-27.0</td>
</tr>
<tr>
<td><strong>Grand Total</strong></td>
<td>14,620</td>
<td>13,950</td>
<td>-4.6</td>
</tr>
</tbody>
</table>


Oxen pull the wheel for a small, open-air sugar cane grinder near Kushtia, East Pakistan. The local cane fields are irrigated by waters from a network of irrigation, drainage, and flood control canals flowing from the Ganges-Kobadak main canal.
Bottles are checked at the Manzoor Glass and Ceramics Factory in Karachi, West Pakistan. Part of the financing for the factory came indirectly through loans from the World Bank made to the Pakistan Industrial Credit and Investment Corporation, Limited.

Achieved in mobilizing domestic private savings were the Government’s liberal economic policies, the gradual elimination of direct controls over prices, imports, and investment decisions. The improved performance of the multitude of credit institutions in providing the private sector both with credit and equity capital was also an important contributing factor. The availability of key imports such as steel and cement, due mainly to the liberal import policy and appropriate credit facilities, had a favorable impact on the outlook of private businessmen, especially in industry. The success of the authorities in creating a favorable climate in which private capital was assured of continuing growth and profit was one of the strongest factors inducing large private investment and saving.

The Plan and the Balance of Payments

The success of the Second Plan was of great help in strengthening the country’s balance of payments. Foreign exchange earnings proved higher, and payments for imports and invisibles were lower, than projected in the Plan. An estimated gap between foreign exchange earnings on the one hand and total imports and payments on the other was 31 per cent less than the Plan projection.

The increase in earnings was mostly due to exports, which rose at an average annual rate
of 7 per cent instead of the 3 per cent envisaged. The rise in raw cotton exports was especially noteworthy; they totaled PRs 1,533 million, compared with a Plan forecast of PRs 1,100 million. Also outstanding were fish and rice exports and earnings from invisibles. Behind this surge in exports lay the increase in agricultural output, with the emphasis on exportable items, and the pursuit of policies which encouraged exports and discouraged consumption. The extension of the Bonus Scheme (a device resulting in partial devaluation of the rupee) to more commodities as well as to remittances from abroad was very effective, as was the adoption of higher taxation and excise duties mainly to discourage consumption and encourage import substitution. The diversification of export markets was also an important factor.

Against these benefits of increased exports had to be set the fact that imports for development (and higher payments for related services) exceeded the estimates of the Plan; this was partially due to a change in definition which now included raw materials intended for development under this heading. But if imports for development were greater than had been planned for, they also bulked much larger than other imports—62 per cent against 38 per cent. Not only that, but they were increasing; during the Second Plan the proportion of development goods and services received rose from 57 per cent of total imports in 1960/61 to 64 per cent in 1964/65 and helped in raising the productive capacity of the country.

The most noteworthy components of non-development imports are raw materials for consumer goods and debt servicing payments. The former increased during the Second Plan from PRs 316 million to PRs 563 million (78 per cent) and the latter from PRs 100 million to PRs 300 million.

Throughout the Second Plan imports were liberalized, although not consumer imports; import and excise duties were used to check these. The object of the liberalization policy was the fuller utilization of industrial capacity and the eventual reduction in the import of items that could be produced locally.

**External Financial Resources**

Pakistan did not, of course, have to rely exclusively on its own earnings of foreign exchange. Like other countries, it attracted private investment from abroad; like other developing countries it was receiving aid in various forms. But unlike most, it was receiving aid in a coordinated manner from a well-conceived and organized consortium. The table below shows that, although almost one third of the external resources that the country had planned for failed to materialize, these foreign resources contributed more than half as much as Pakistan's own earnings toward meeting its needs for foreign exchange. Of the external resources, a half (actually 51 per cent) came in the form of project assistance. This figure illustrates how vital is the role of foreign assistance, even in a developing country which is itself making prodigious and outstandingly successful efforts to advance its economy.

**THE THIRD FIVE-YEAR PLAN**

**Size of the Plan**

On July 1, 1966, Pakistan entered upon its Third Five-Year Plan, for which a development program costing PRs 52,000 million is
Foreign Exchange Need and Financing
During the Second Plan
(In millions of Pakistani Rupees)

<table>
<thead>
<tr>
<th></th>
<th>Plan</th>
<th>Target</th>
<th>Actuals</th>
<th>Percentage Fulfillment</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Imports</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Development imports</td>
<td></td>
<td>12,730</td>
<td>13,130</td>
<td>116.7</td>
</tr>
<tr>
<td>Nondevelopment imports</td>
<td></td>
<td>7,950</td>
<td>7,550</td>
<td>93.2</td>
</tr>
<tr>
<td><strong>Financed by</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Own earnings</td>
<td></td>
<td>11,250</td>
<td>10,950</td>
<td>68.9</td>
</tr>
<tr>
<td>External resources</td>
<td></td>
<td>10,950</td>
<td>7,550</td>
<td></td>
</tr>
<tr>
<td><strong>External Resources</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Project aid</td>
<td></td>
<td>6,500</td>
<td>600</td>
<td>123.4</td>
</tr>
<tr>
<td>Commodity aid</td>
<td></td>
<td>3,500</td>
<td>451</td>
<td>75.2</td>
</tr>
<tr>
<td>Technical assistance</td>
<td></td>
<td>350</td>
<td>432</td>
<td>123.4</td>
</tr>
<tr>
<td>Foreign private</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>investment</td>
<td></td>
<td>600</td>
<td>600</td>
<td>100.0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td>10,950</td>
<td>7,550</td>
<td>68.9</td>
</tr>
</tbody>
</table>


An Ambitious Plan

Clearly, Pakistan's Third Plan is ambitious. But it is also realistic. For one thing, it has the same general shape as the successful Second Plan. For another, the Government is taking steps to ensure that its crucial assumption about the rate of marginal saving is solidly based; among other measures it is planning to revise the structure of interest rates to encourage people to save more. The new Plan envisages—on the basis of past experience—increases in defense and administrative expenditures of 2 per cent and 3 per cent a year, respectively. The annual increase in the recurring costs of development expenditure, by contrast, is put at 13 per cent. And the burden of debt service carried by Pakistan—as by so many other developing countries—is acknowledged by allowing an annual increase of 16 per cent.

Total gross capital receipts for the government sector are estimated at PRs 3,555 million, consisting of small savings, public borrowings from nonbank sources, depreciation and other reserve funds. Capital liabilities, which are mostly repayment of foreign loans, are projected at PRs 1,155 million, leaving net capital receipts of PRs 2,400 million.

Investment in the private sector during the Third Plan is estimated at PRs 22,000 million compared with the Second Plan target of PRs 8,380 million and an estimated actual performance of PRs 13,680 million.

Private domestic savings are expected to constitute by far the largest component (86 per cent) of the sources of financing available for the private sector program. The other com-
Projections of Local Resources, Consumption, and Investment
(In millions of Pakistani Rupees)

<table>
<thead>
<tr>
<th>A. Resources</th>
<th>End of Second &amp; Third Plan Per Cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. GNP (factor cost)</td>
<td>43,365 59,400 37</td>
</tr>
<tr>
<td>2. Indirect taxes (net of subsidies)</td>
<td>2,175 3,365 55</td>
</tr>
<tr>
<td>3. GNP (market prices)</td>
<td>45,540 62,765 38</td>
</tr>
<tr>
<td>4. Imports of goods and services</td>
<td>6,990 8,985 29</td>
</tr>
<tr>
<td>5. Total National Resources</td>
<td>52,530 71,750 37</td>
</tr>
<tr>
<td>B. Expenditures</td>
<td></td>
</tr>
<tr>
<td>6. Private consumption</td>
<td>35,330 45,900 30</td>
</tr>
<tr>
<td>7. Public consumption</td>
<td>5,094 7,250 42</td>
</tr>
<tr>
<td>8. Total consumption</td>
<td>40,424 53,150 31</td>
</tr>
<tr>
<td>9. Plan investment</td>
<td>6,776 11,400 68</td>
</tr>
<tr>
<td>10. Noninvestment plan development outlay</td>
<td>655 1,100 68</td>
</tr>
<tr>
<td>11. Other investment expenditures ¹</td>
<td>1,375 900 35</td>
</tr>
<tr>
<td>12. Changes in stocks</td>
<td>250 400 60</td>
</tr>
<tr>
<td>13. Total plan expenditures</td>
<td>9,056 13,800 52</td>
</tr>
<tr>
<td>14. Total domestic expenditures</td>
<td>49,480 66,950 35</td>
</tr>
<tr>
<td>15. Exports of goods and services</td>
<td>3,050 4,800 57</td>
</tr>
<tr>
<td>16. Total expenditures from national resources</td>
<td>52,530 71,750 37</td>
</tr>
</tbody>
</table>


¹ Including nonmonetized investment and investment in Indus Basin Works.

Pakistan's total imports and payments during the Third Plan period are estimated at PRs 35,500 million, and total exports and receipts at PRs 20,000 million, leaving a gap of PRs 15,500 million that must be obtained from abroad.

Annual imports are expected to increase from PRs 3,050 million in 1964/65 to PRs 4,800 million in 1969/70; a rate of increase of 9.5 per cent annually, compared with an increase of 7 per cent during the Second Plan.

Invisible earnings are expected to increase from an estimated PRs 530 million in 1964/65 to PRs 680 million by 1969/70. The authorities hope to achieve this increase by improving and extending the country's air and shipping services as well as by encouraging larger remittances from Pakistanis living abroad.

Of the anticipated total imports (goods and services) of PRs 35,500 million, as much as PRs 22,500 million—or 63 per cent—are expected to be development imports consisting either of capital goods or of raw materials for the manufacture of capital goods. Nondevelopment imports and invisible payments are estimated to total PRs 13,000 million. The latter are composed of consumer goods imports, imports of raw materials for consumer goods, and

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payments for services and debt servicing. The high relative increase in the latter is noteworthy, as can be seen in the following table.

### Balance of Payments Projection During the Second and Third Plans

*(In millions of Pakistani Rupees)*

<table>
<thead>
<tr>
<th></th>
<th>Second Plan</th>
<th>Third Plan</th>
<th>Percentage Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Development goods and services</td>
<td>12,730</td>
<td>22,500</td>
<td>76.7</td>
</tr>
<tr>
<td>Nondevelopment goods and services</td>
<td>7,000</td>
<td>10,190</td>
<td>45.6</td>
</tr>
<tr>
<td>Debt services</td>
<td>950</td>
<td>2,810</td>
<td>195.8</td>
</tr>
<tr>
<td>Total Payments</td>
<td>20,680</td>
<td>35,500</td>
<td>71.7</td>
</tr>
</tbody>
</table>

*Financed by:*

<table>
<thead>
<tr>
<th></th>
<th>Second Plan</th>
<th>Third Plan</th>
<th>Percentage Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Own earnings</td>
<td>13,130</td>
<td>20,000</td>
<td>52.3</td>
</tr>
<tr>
<td>External Resources</td>
<td>7,550</td>
<td>15,500</td>
<td>105.3</td>
</tr>
<tr>
<td></td>
<td>20,680</td>
<td>35,500</td>
<td>71.7</td>
</tr>
</tbody>
</table>


1 P.L. 480 and Indus Basin imports and financing are excluded.

Since the Third Plan was launched priorities were changed somewhat to raise that of agriculture at the expense of other sectors, such as social welfare and construction. A special importance is now being given to industrial projects that are related to agriculture.

As has already been said, the credit for Pakistan's success in economic development should go to these parties: the Pakistani people, their Government, and foreign governments, international agencies (the chief of these being the World Bank), and individuals.

The Pakistani people doubled their efforts to produce more and yet saved a significant portion of their new production for investment. The Government planned well and wisely, leaving to the private sector a great deal of freedom and a wide scope for initiative. The foreign community, encouraged by the determination of both government and people, coordinated their efforts with that of the country and provided the necessary foreign exchange.
Trade and Exchange Policies for Economic Development

What foreign trade and exchange policies are most compatible with, or conducive to, economic development? This article describes the issues which have provoked some of the sharpest differences of opinion on economic policy in the postwar years.

Margaret G. de Vries

Throughout the nineteenth century and about the first third of the twentieth, traditional economic theory had been the cornerstone of a strong case for free trade. Only two exceptions to free trade were recognized as having a sound economic base: tariff duties to protect “infant industries,” which were expected eventually to be able to compete in world markets without protection, and duties to raise revenue. International payments were governed by the “rules of the game” required by the gold standard—exchange rates which were fixed within narrow limits and the complete absence of any trade and exchange controls. Little, if any, distinction in the applicability of these policies was made between the highly industrialized countries and the rest of the world.

The Policy Dilemma of the Last Two Decades

After World War II the less developed countries were faced by a policy dilemma. Many economists began to believe that as these countries placed primary emphasis on accelerating their economic growth, they would have to deviate from the orthodox policies. In their view, the less developed countries had not benefited as much from free trade as had the highly industrialized nations. Orthodox policies had oriented the economies of the developing countries excessively toward the production of agricultural commodities and raw materials, often with primitive techniques. Relatively low prices in world markets for these products—and sharp fluctuations in these prices—had condemned these countries to subsistence living standards. Foreign investment, while often improving methods of export production, had not given momentum to the domestic economy. For these reasons, several economists became convinced that the way to economic development lay through accelerated industrialization and the attainment of diversified economies and that these would necessitate
considerable trade and exchange controls and higher tariffs for long periods of time. (For a detailed discussion of the views of different economists, see the author's article, "Trade and Exchange Policy and Economic Development: Two Decades of Evolving Views," *Oxford Economic Papers*, Vol. 18, No. 1, March 1966.)

In any event the policymakers in most developing countries were in the throes of several trade and balance of payments problems, together with institutional and administrative difficulties in choosing among alternative solutions, which had driven them to a variety of trade restrictions, exchange controls, multiple exchange rates, and rising tariffs. Since economic development would, of course, require decades, these problems and practices, however much they might deviate from traditional policies, could hardly be regarded as temporary.

Many economists, nonetheless, continued to believe in the orthodox policies. In their view, extensive use of controls interfered with the optimum allocation of resources, and they argued that the poorer countries especially could ill afford to neglect or lose the benefits of international trade. These countries should not, in a rush to industrialization, misallocate scarce resources into uneconomic industries.

Debates between protectionists and orthodox economists were not new; they had been going on for the last 200 years. These earlier differences, however, had been between economists and noneconomists; the postwar differences of view were among professional economists themselves, who were no longer agreed as to the benefits of liberal trade and payments policies for the primary producing countries.

In the last 20 years this issue has been a crucial one, not only for economists but also for government officials, who must formulate and implement policies on exchange rates, trade and exchange controls, and tariffs, as a matter of daily routine. The debate has been of direct concern to organizations dealing with international codes of behavior in these matters, such as the International Monetary Fund and the General Agreement on Tariffs and Trade (GATT). It was the purpose of the United Nations Conference on Trade and Development (UNCTAD), held in Geneva, in 1964, to seek new solutions to the trade and payments problems of developing countries.
The Balance of Payments Problems of Developing Countries

Although developing countries have used trade and exchange controls, including multiple rates and tariffs, for several reasons, the two principal trade and payments problems of developing countries have been, first, recurrent, or even continuous, balance of payments deficits and, second, the need to protect new industries. Balance of payments deficits have become virtually synonymous with development. Economic development usually involves the acceleration of investment. And any gap between the expanding level of investment and domestic savings results in a balance of payments deficit. Unless this gap is filled by foreign savings—that is, by private foreign investment or foreign aid—a deficit emerges that somehow has to be managed.

In practice this means that, as investment is increased, imports of capital goods are directly enhanced. Often there is also an even greater rise in imports of raw materials, fertilizer, fuel, and other commodities to keep an expanding domestic economy supplied. Moreover, as consumer demand increases and new domestic products for consumption are not yet sufficiently available, additional pressure is usually brought on consumer imports. These pressures may be considerably aggravated if development is financed by strongly inflationary methods (see Graeme S. Dorrance, “Rapid Inflation and International Payments,” Finance and Development, Vol. II, No. 2, June 1965).

These import needs usually outrun the ability to export. World trade in primary commodities, for at least the last three decades, has lagged far behind world trade in manufactures. Switching to manufactured exports has been a slow and difficult process. The magnitude and persistence of payments deficits accompanying development varies from country to country and depends on many factors: the rate of investment, the composition of natural resources and especially of exports, the rate of growth of population, the rate of increase of consumption, the rapidity with which consumable products result from new investment, the degree of self-sufficiency of the economy in foodstuffs and fuels, and the extent to which new local industries can use domestic raw materials. Moreover, there is the all-important question of the particular financing policies pursued. In the longer run, a changed allocation of resources, which may be facilitated by long-term foreign investment or loans, for example through the World Bank, may alter the structure of the economy so as to reduce these problems.

In addition, the balance of payments positions of developing countries are very vulnerable to crop failures, declines in world market prices for their principal exports, changes in demand for particular products, and unexpected capital flight. Since the foreign exchange reserves of most developing countries are inadequate to cope with these deficits for more than a very short time, unless recourse can be had to secondary reserves—for example, through the International Monetary Fund—a choice among alternative policies must be made. Exchange rate devaluation is often rejected, or unduly postponed, because it is thought that it will not significantly increase the volume of exports and yet may worsen inflationary pressures and raise the prices of imports. The desire to reduce inflation makes it necessary to raise taxes—which runs into political opposition—or to cut back expenditures, which nearly always entails reductions in investment. The
The policymaker in a developing country is continuously grappling with the problem of how much stability to preserve, through credit restriction and budgetary balance, and how much expansion to permit in the interest of more rapid investment. When relatively free trade and payments policies are selected as a goal, the hands of the policymaker are more or less tied to monetary stability. Hence, controls on imports and outgoing payments seem to be the only way out, at least temporarily.

The Need for Protection

The other main trade problem of developing countries is that of the need for protection of new industries. The justification for such protection is the same as in traditional theory: during the early stages of production a new industry is not fully effective, as the level of output is below optimum, and costs are temporarily higher than they will be in the longer run.

Important differences of view arise on how much protection is desirable for developing economies and by what methods it should be applied. Some economists believe that all manufacturing industries in developing countries should be protected. These industries, it is argued, are at a disadvantage compared with agriculture: they must, for example, pay higher wages in order to attract rurally oriented workers. Hence, without some protection, manufacturing industries will be undersold by imports. Other economists argue for much more limited and selective protection, so as not to encourage inefficient industries.

Economists have usually preferred subsidization of domestic output to tariff protection on competing imports. Since subsidies lower the prices of domestic products while tariffs raise the prices of foreign imports, the former benefit both consumer and producer. Since subsidies have usually been politically difficult to accept, protective duties have usually been considered acceptable, as they, in contrast to quantitative restrictions, allow the price mechanism to operate. However, in the last two decades many developing countries have been implementing a great deal of protection through quantitative limitations on imports. Even outright import prohibitions on many items have not been uncommon. There are several reasons for this. Tariffs may not have been revised for many years and hence have become unrelated to current price levels. They have also been subject to international commitment. In many instances, tariffs have been considered ineffective as a means of keeping out competing imports. Moreover, where quantitative restrictions were required for balance of payments purposes, they served simultaneously to protect domestic industries.

Recent Shifts in Policy Approaches

In the last few years, although they are still a long way from complete agreement, the two groups—the protectionist school and the orthodox school—have gradually moved closer together. The majority of economists seem to have come to the belief that no universal trade and payments policy applies to all situations of development, and that trade and exchange policies need to be tailored to individual circumstances.

This lessening of the differences in viewpoint has come about both because of advances in economic thinking and because of additional experience with various policies in
developing countries. Modern refinements in international trade theory have introduced many qualifications into the free trade approach: certain circumstances where protection can be defended, especially through tariffs, and for developing countries, are now widely recognized. Furthermore, most of the policy conclusions of modern balance of payments theory have become more qualified and complex than the conclusions of the gold standard era: there is need to “manage” the balance of payments with some admixture of exchange rate devaluation, internal monetary and fiscal policies, and commercial policy.

On the other hand, as a result of the practical experiences of countries, there has been a marked disenchantment with the results of import restrictions, trade and exchange controls, and multiple rates. Commercial and political pressures for changes in licensing policies or in multiple rates and frequent ineffectiveness of control have often grown into serious problems for exchange control authorities.

The many distorting effects on production and investment caused by excessive use of restrictions have become more evident. High-cost industries, as well as excessive assembly-type industries that are unduly dependent on imported parts, have often developed under an umbrella of protection. Quantitative controls on consumer imports have not, for the most part, been a successful means of obtaining additional capital goods for a protracted period of time: the economy tends to become starved for consumer goods or for the raw and intermediate materials and fuels with which to produce them domestically. Investment in export industries has often been neglected, thus further aggravating the payments deficits. As exchange rates become increasingly unrealistic, quantitative restrictions often tend no longer to restrain imports satisfactorily, or exports begin to need some special inducement: exchange taxes or some export promotion devices have to be introduced.

For all these reasons, many developing countries have, in the past six or seven years, been increasingly turning away from restrictive policies and reinstituting more liberal policies. Several have sharply devalued their currencies, eliminated long-standing multiple exchange rates, and reduced their quantitative restrictions (see “Twenty Years of Par Values, 1946-66,” by M. de Vries, Finance and Development, December 1966).

The Search for New Solutions

Plagued by lack of adequate solutions to the free trade versus restrictions dilemma, many economists in recent years have begun to seek new solutions to the trade and payments problems of development. Ways and means of accelerating foreign capital movements in order to finance development are continuously being explored. However, in the last few years increased attention has been given to the possibilities of expanding exports of primary producing countries. Not only are such exports a satisfactory way of financing development and of minimizing balance of payments deficits, but they are a preferred way. Several studies by the United Nations, the Economic Commission for Latin America (ECLA), the Economic Commission for Asia and the Far East (ECAFE), the World Bank, and others have shown noteworthy correlation between the growth of exports of a country and its over-all rate of growth: countries with the greatest expansion
of exports have also experienced the most rapid rate of over-all growth: the examples of Mexico, Peru, Japan, Venezuela, Israel, the Philippines, and Thailand, among others, are often cited. Exports have been the key to successful development because they provide the most vital wherewithal to purchase the imports required for development. Moreover, export expansion seems to generate additional growth in other sectors of the economy.

The focus of the search in recent years, for new ways to assist developing countries, accordingly, has been on ways and means of expanding their exports. Much greater attention has been given to the extent and causes of the secular lag in world trade of primary products. The degree to which certain commodities have been affected more than others is also being examined. One factor which has been especially singled out for scrutiny is the problem of the trade barriers of the major importing countries. These barriers include the agricultural protective policies of several industrial nations, import quotas, internal excise taxes on agricultural goods or other commodities such as tropical beverages, as well as policies to protect their own industries from what is feared will be low-wage competition from the developing economies. Such barriers on imports by industrial nations have come under increasing attack.

Greater attention has been given to the extent to which European countries which belong to the Common Market may, as a consequence, divert their consumption away from the agricultural production of the developing countries in Latin America, Asia, and Africa to the products of other European countries with which they have special trade arrangements. Efforts have also been accelerated toward regional economic integration in Asia, Africa, and Latin America. An organization called LAFTA—Latin American Free Trade Association—involving Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, and Uruguay—was established in 1961. A Central African Customs and Economic Union (UDEAC)—involving the Central African Republic, Chad, Congo (Brazzaville), Gabon, and Cameroon—came into being in January 1966. The possibilities of other customs unions, free trade associations, and special tariff concessions are continuously being investigated as ways for developing economies to expand their exports, particularly of new manufactured products, through increased trade with each other.

The shift of focus from imports to exports as the important trade factor in economic development has occasioned a parallel policy shift from measures applied by an individual country to international action. There is a new general awareness that the problems of expanding exports of developing countries, except for temporary and unusual circumstances, can be tackled only as a cooperative venture by a group of developing countries acting in unison, or on an international basis in conjunction with the individual countries as well.

Economic integration on a regional basis, for example, requires the working out of detailed arrangements among developing countries. A reduction in the trade barriers of the industrial nations can be achieved only with the cooperation of the United States, Canada, and the Western European countries concerned. The difficult problem of the fluctuations in raw material prices in world markets
Trade and Exchange Policies

can be solved only through agreement between the major supplying and the major consuming countries.

In the last few years there has also been considerable discussion in international forums of these problems and of possible solutions. Various exceptions to the rules are gradually being worked out by the GATT. In the last few years, for example, it has been decided that in some circumstances developing countries may receive the benefits of tariff concessions by industrial nations without having to make similar concessions themselves. In 1963 the International Monetary Fund introduced a new facility known as “Compensatory Financing” to provide short-term financing assistance to countries suffering from fluctuations in exchange receipts of exports of primary products. In its 1966 Annual Report the Fund reported that it was re-examining this facility, giving weight to various subsequent suggestions. Following the UN Conference on Trade and Development in 1964, a new permanent body of UNCTAD has been set up to consider new proposals for dealing with the special trade problems of developing countries. The World Bank has also been considering some new supplementary financing arrangements.

It is not yet clear just which solutions are the most desirable or likely to be the most acceptable to all concerned. Nonetheless, it is apparent that there is increasing recognition of the need for internationally agreed workable policies. Hence, the prospect is for even greater discussion, in the future, of these problems and appropriate policies.

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Balance of Payments Problems of Developing Countries

The author discusses some of the special difficulties encountered by developing countries; in a later article he will turn to the methods they may adopt to overcome these.

Poul Høst-Madsen

The balance of payments problems of the developing countries must be seen against the background of the two circumstances that dominate their entire economic being—the endeavor to better the lives of their people and the high rate by which their populations are increasing. As to economic development, a target of 5 per cent a year for the increase in real output has won wide acclaim. This target, which implies a considerably smaller increase in per capita output or standard of living, say, 2-3 per cent, must be assumed to involve a rise in imports that is not, in general, likely to be less than proportionate to the rise in real output.

On the basis of certain assumptions regarding the growth rates for the economies of the developing countries and their future receipts from exports of goods and services, it is possible to deduce, as has been done in connection with the UNCTAD Conference, that they will be facing a rising “foreign exchange gap.” Such a “foreign exchange gap,” to the extent that it cannot be covered by an inflow of foreign aid and capital, is not, of course, to be regarded as a forecast of a deficit in the developing countries’ balance of payments, but rather an indication of the conflict between the assumed development targets and current expectations for the long-term trend in the developing countries’ receipts from exports and foreign financial resources, a conflict which will have to be reconciled in some way. It must be regarded primarily as a problem of development rather than as a balance of payments problem.

The fact remains, however, that unless the exports of the developing countries rise over the long run at a rate sufficient to support an adequate growth rate, pressures on their balance of payments are likely to persist. It is true that efforts to increase a country’s rate of growth beyond what can be sustained by its foreign receipts are likely to result in wasteful policies of stop and go, and, therefore, to have the opposite result to that intended. Nevertheless, it is one of the facts of life that a number of developing countries have not adapted their development plans to their true foreign situa-
BOP Problems

Poul Host-Madsen is Deputy Director of the European Department of the Fund. He is a graduate of the University of Copenhagen, and was with the Danmarks Nationalbank before joining the Fund in 1947.

Exports

A rational policy for economic growth is made difficult in the developing countries by relatively large short-term fluctuations in their foreign exchange receipts from exports and the slow long-term growth of these receipts (especially when compared with the growth of the population).

The export earnings of the primary producing countries, particularly the developing countries, show, in general, wider short-term fluctuations than those of the industrial countries. This is largely because less elastic supply conditions in the short run subject the prices of most primary products to much wider fluctuations than those of manufactured goods. In addition, the volume of exports of individual primary producing countries may exhibit large fluctuations due to weather conditions, which usually affect the exports of the developed countries much less. There are great differences among exporters of primary products in the magnitude of these fluctuations. The industrial countries do not, of course, escape similar fluctuations; indeed, the export records of some primary producing countries, notably the oil producers and those whose exports are relatively diversified, are more stable than those of some of the industrial countries. On the whole, however, export fluctuations have generally been much wider for the primary producing countries than for the industrial countries.

Terms of Trade

An even more serious problem for the great majority of the developing countries is the adverse longer-term trend in their terms of trade (see Charts I and II). A declining trend in the prices of primary products, which was particu-
larly pronounced for the exports of the developing countries, set in after the temporary Korean boom, while at the same time prices of manufactured products moved upward. In the course of the 1950's the ratio of prices for primary products to those of manufactured products declined by more than 20 per cent; since then there has not been much change in this ratio; primary product prices have improved somewhat during the last five years, but prices of manufactured products, after a long period of stability, have again begun to edge upward. The decline in ratio of primary product prices to prices of manufactured products somewhat overstates the decline in the terms of trade of the developing countries because they are not only exporters but also importers of primary products, and because they have also benefited from a declining trend in freight rates. In fact, their terms of trade have declined considerably less than might be suggested by the comparison of prices for the two types of goods. However, the volume of exports has also risen much more slowly in the developing countries than in the industrial countries. Over the decade 1950-60, for instance, the volume of exports of the developing countries rose by a little over 50 per cent, while those of the high-income countries rose by about 90 per cent. Because of changes in the terms of trade there was an even greater disparity in the growth of the purchasing power, in terms of imports, of the export receipts of the two groups of countries. The import capacity of the developing countries rose only 44 per cent over the decade 1950-60, while that of the high-income countries doubled. On a per capita basis the relative position of the developing countries

Chart I. IMPORTING POWER OF EXPORTS AND TERMS OF TRADE: FIVE-YEAR MOVING AVERAGES, 1950-63 (1950 = 100)
was even more unfavorable because of the more rapid population increase; their import capacity per capita rose only some 15 per cent, while that of the high-income countries rose five times as fast.

The figures quoted for the developing countries include oil exporters which have increased their export receipts much more than the average. When these are excluded the per capita import capacity of the remaining countries rose only at a very low rate.

Developments during the early 1960's have been somewhat more favorable to the developing countries than during the preceding decade. Between 1960 and 1964 their import capacity appears to have risen at an annual rate of some 6 per cent. However, developments during this relatively short span of years cannot be interpreted as an indication of a basic change in the trade prospects of the developing countries.

Services

Services are much less important than trade in the balance of payments of the developing countries. According to a compilation which the Fund has recently made, receipts for services amounted to less than one fourth of those for merchandise exports, and payments for services to some 40 per cent of the value of merchandise imports over the 1961-64 period. In the aggregate, receipts from foreign travel and government expenditures are the most important credit items, but both tend to be concentrated in certain countries while being relatively unimportant for the majority. On the debit side the two largest items are payments

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Chart II. IMPORTING POWER OF EXPORTS AND TERMS OF TRADE: FIVE-YEAR MOVING AVERAGES, 1950-63 (1950=100)
for transportation, mainly import freight, and investment income.

The statistics on the balance of payments of the developing countries are much less complete and reliable than those on merchandise trade. For this reason only the most general observations are made here. During 1961-64, the annual average deficit of the developing countries on services account was about $4.4 billion, of which $3.1 billion was accounted for by investment income. Of net investment income payments about $2.5 billion again referred to direct investment, much of which is related to export production, oil being the most important commodity. Such investment income payments must be seen in the broad context of the operations of the direct investment companies concerned. These operations involve transactions such as exports, imports, investment income, and capital movements, but taken together these usually leave substantial net foreign exchange receipts to the country in which the investment takes place. Income from direct investment in other than export industries is related in part to the production of types of goods which might otherwise have been imported, and there is also some question whether such investment income payments, and the related inflow of capital, usually involves a net drain on the balance of payments of the developing countries. Other net investment income payments in the 1961-64 period were relatively modest and can best be discussed in the context of the debt problem of the developing countries.¹

¹ See, for instance, 1965 Annual Report, International Monetary Fund, Chapter 3.
Inflow of Financial Resources: Basic and Over-All Balances

Since World War II the balances of payments of the developing countries have been supported by a substantial inflow of financial resources from the developed countries in the form of official economic aid and foreign investment. In the early 1960's such inflows in the aggregate amounted to about one fourth of the export receipts of these countries. Measured in terms of domestic investment, the total inflow of financial resources has also been quite significant, amounting, in the aggregate, to about 18 per cent of the gross domestic capital formation of the developing countries during 1960-62. The rise in the flow of such resources was accounted for almost exclusively by official aid; the inflow of private long-term capital has failed to rise since the late 1950's. During the last few years the rise in total receipts of financial resources appears to have been leveling off.

Charts III and IV provide a general indication of the balance of payments of developing countries during 1958-65. They show aggregate balances of these countries, and various subgroups, on account (1) of goods, services, and private transfers, and (2) such transactions plus governmental transfers and all long-term capital transactions. The second balance, referred to as the "basic" balance, does not include movements of short-term capital and errors and omissions which have in most years represented a net outflow in the aggregate balance of payments of the developing countries, as is apparent from the chart. It is sometimes believed that this net outflow gives evidence of a flight of capital from the developing countries, but it would be a mistake to accept such a statistical residual as a measure of capital flight. While it is widely held that an outflow of local capital from the developing countries has greatly added to their development and balance of payments problem, we have no way of knowing how large the amounts involved are. This remains a matter of speculation.2

The balance of payments structure of the developing countries that emerges from these charts is one of persistent deficits on current account, covered over the long run by an almost equivalent inflow of long-term financial resources (including government transfer payments), leaving, again over the long run, an approximate balance in the over-all balance of payments. Moderate surpluses arose, in two periods of rising prices for primary products, but such surpluses have had no tendency to persist, as imports are likely to rise in the wake of an increase in exports. This reflects a relatively low marginal value attached in the developing countries to accumulating reserves, compared with domestic capital formation. On the other hand, the low level of reserves and credit facilities available to these countries explains why deficits cannot persist. In these circumstances, the balance of payments problem of the developing countries tends to express itself in the use of restrictive devices and in depreciation of their currencies rather than in realized balance of payments deficits.

Inflation and the Balance of Payments

The balance of payments problem of developing countries has in many instances been aggravated by inflationary price rises due to an

excessive monetary expansion, the primary source more often than not being a government deficit. Such deficits are bound to arise whenever a government is endeavoring to push expenditures for development beyond what can be financed from domestic noninflationary sources and foreign aid and capital (although it can also arise because a government’s current expenditures are unduly high). In the short run domestic savings may perhaps sometimes be increased by resort to inflationary financing; but in the long run the effect of inflation on saving is bound to be harmful. In addition, inflation and the disturbances to international payments that it brings about tends to discourage an inflow of foreign capital, while stimulating an outflow of capital. Inflation, therefore, will in the end reduce the resources available to finance development expenditure.

The use of inflationary financing is usually soon reflected in the balance of payments. Insofar as inflation results in expenditures for domestic capital formation in excess of domestic saving and the net inflow of financial resources from abroad, an over-all deficit in the balance of payments is bound to arise, quite aside from any rise in prices. In addition, the rise in domestic prices, costs, and incomes with which inflationary financing is associated, discourages exports and stimulates imports. These developments are also likely to worsen the capital account of the balance of payments as suggested above.

This article, and the article to appear in a subsequent issue, are based on two papers presented by the author in November 1965 for discussion at a training program organized by the central banks of Southeast Asia, New Zealand, and Australia (SEANZA). This first article omits a section describing the relationship of surplus and deficit in the balance of payments to saving, investment, and international capital flows of autonomous character, since this subject has been covered in two earlier articles in Finance and Development.
Economists, Engineers, and Development

The author suggests that in considering development possibilities men schooled in engineering disciplines often take too restricted a view of the possibilities of economic choice, while economists are too little schooled in the technical aspects of evaluating projects. Despite difficulties of communication they must work more closely together.

Robert Sadove

Engineers comprise almost 10 per cent of the professional staff of the World Bank, not a surprising figure considering their important function in its work. The primary responsibility of the Bank's 75 specialist engineers is to appraise the projects for which loans are requested, and in discharging it they must bear in mind not only the engineering, but also financial, managerial, organizational, and economic aspects.

The engineers, who come from many countries, work closely with economists and financial analysts in reaching judgments on the

An economist and engineer from the World Bank look over the site of the new Bank building now under construction in Washington.
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projects, the amounts of loans, the grace periods, and the contractual arrangements to ensure successful construction and operation of the projects recommended. After loans are made, the Bank’s engineers visit the projects during construction to inspect progress, to determine if the various conditions set forth in the Loan Agreements are being observed and, in general, to get at the problems. If major problems are found, they recommend a course of action for the Bank to take, and on lesser problems they assist in ironing out the difficulties. The engineering staff does not undertake any engineering work for borrowers. This is almost always done by consultants retained by borrowers; the Bank merely reserves the right to approve the borrower’s choice of consultant.

However, the Bank’s technical assistance work involves it more directly with engineering firms. Besides lending for projects, it also carries on a small technical assistance program financed on a grant basis—currently running at about $12.5 million a year—and administers a much larger amount as Executing Agent for the UN Special Fund. Expenditures under these technical assistance programs are usually for feasibility studies designed to assess the potentialities of resources within a defined area or sector of an economy or to identify and formulate projects. When the Bank is meeting the costs of such studies, it selects the consultants itself.

To assist it in judging the ability of consultants to carry out proposed tasks the Bank maintains a comprehensive file of the names and experience records of all firms desiring to be included—about 1,800 of them at present. The Bank takes a wholly impartial view in the selection and approval of consultants; it wants only to be assured that any assigned task will be performed with full professional competence.

Problems of New Projects

An increasing proportion of the World Bank work has been in the poorest of the developing countries, in Asia and Africa. These countries are likely to become an increasingly important part of the total international market for engi-
Economists and Engineers

Surveying in the Congo (Brazzaville): “An increasing proportion of the World Bank work has been in the poorest of the developing nations, in Asia and Africa.”

eering know-how. To work effectively in an environment of such extreme poverty is far from easy. One has to start with very basic matters; for example, food may have to be distributed to local employees if costly sicknesses are to be avoided. Difficult climatic conditions and poor accommodations can seriously impair the effectiveness of incoming engineers who are used to a less rigorous standard of living. The scarcity of statistical and factual information—especially accurate information—can cause enormous waste of time and money. It is imperative that a carefully planned survey of all available data first be carried out; and then great care must be taken in drawing inferences from it. Resistance to change and innovation is a serious problem; it may be worth employing an individual who is particularly knowledge-
able in fields such as anthropology and sociology and use his knowledge to get around obstacles posed by local tradition. However, a firm must have a staff that is knowledgeable about the area. Probably it will still need to work jointly with local partners if it is to avoid costly mistakes resulting from ignorance of local language, laws, customs, and traditions.

Economy is, of course, the very essence of engineering and this is particularly so in the developing countries. To paraphrase the words of the Duke of Wellington, “an engineer can do for one dollar a job that any bungler can do for two.” But the concept of economizing involves more than trying to meet a given need at the least cost.

Sampling silt from a river bed in Thailand: “The scarcity of the statistical and factual information can cause enormous wastes of time and money.”
Defining the Task

To get a problem into manageable form engineers naturally try to define it in as specific terms as possible—for instance, the construction of an urban water supply system that is technically efficient and meets given technical standards of purity. Once the requirement has been precisely defined, the problem boils down to finding the least costly way of meeting it. The most obvious alternative paths leading to similar results are carefully considered; each path is costed in detail and then the costs are compared to show which is the cheapest, given some discount rate. Straightforward as this type of job may appear, it is not always performed well. Often the Bank finds that techniques are recommended which are inappropriate to countries which have abundant cheap labor but little capital—as most developing countries have. For instance, the design of a water supply system for a large Far Eastern city included the use of an advanced electronic control system for checking water levels. It was found that the job performed by the control system could be done adequately by a man with a pencil and paper and a bicycle to carry him from one check point to another. The engineers had obviously allowed their desire for technical perfection to run away with them, and in fact recommended a solution to the water supply problem that was not the least costly. Sometimes, of course, the most modern technique is so much more efficient than the old that the solution to a particular problem will be the same in advanced countries and less developed countries alike. Also, the skilled workers required by a plant may be even more expensive in the less developed country, which is desperately short of them, than they are in the advanced country where the general wage level is higher. Occasionally, an expensive modern production method may be preferable to an older and cheaper one even in a less developed country, because use of the modern method minimizes the need for lengthy training of skilled craftsmen.

Provided that engineers bear in mind the possibility of saving money by varying techniques of production according to local conditions, the problem of selecting an optimum technique for reaching a given objective can usually be solved reasonably precisely by calculating comparative costs.

But this type of procedure can also very easily be highly misleading. All too often and easily, the cost-comparison approach is combined with reliance on standards and technical and economic coefficients developed in other parts of the world. That is, of course, part of the purpose of employing an engineering firm from another country: you hope to get a transfer of engineering technique and judgment. These judgments and implicit references to standards and coefficients developed elsewhere may lead a country to invest in a project that is quite inappropriate to its over-all economic conditions. Objectives, standards, design criteria, technical coefficients, economic coefficients, “normal” growth rates—all have to be re-evaluated for application to a particular developing country.

To take the case of objectives and the standards used for defining them, can the engineer—or the economist—really count on his “fixed” requirements being fixed? To my mind the subconscious judgments of engineers and economists play a much bigger role in the evaluation of projects in the developing countries than they should do. Technical
standards used in the design of projects are often applied with little change from one country to another. Yet the costs of attaining these standards differ considerably. Furthermore, the benefits to be derived in the form of reduced risks or lower operating costs will also vary greatly among countries. Cost-benefit ratios are often misleading because they do not explicitly treat these points. It is poor economics to accept as unavoidable a specific requirement of a system without considering whether another higher or lower standard might not be more appropriate to local cost conditions and time horizons.

Clarifying the Standards

One way to handle this problem is to evaluate carefully the range of relevant standards or objectives and then to present a clear statement for each standard of the costs involved in attaining that standard compared with ones slightly below it and above it. It has been estimated, for instance, that to meet fully at all times of the year all the demands placed on one major water system would involve expansion of storage capacity by 20 per cent—an enormous investment. No such investment would be required if people could be persuaded to cut down their demand for water by a few percentage points for short periods. The question, therefore, is: would consumers be prepared to pay for the water that they received at these critical periods the full cost of providing that water? If the answer is no, as it probably would be, the supposedly fixed “requirements” dissolve. Requirements and standards must always be treated flexibly, as a variable, and not (as they too often are) as orders from on high which it would be an impertinence to question.

The range of possible choice in an investment program is often much wider than is readily apparent. Sometimes the problem is an institutional one: those with funds to spend see only a few of the alternative ways of spending them. Moreover, costs and benefits are not always calculated in such a way as to be comparable with the costs and benefits attributable to alternative uses of funds available for investment. In public projects the costs and benefits relevant to the decision whether or not to go ahead must be stated in such a form that they clearly indicate the benefit which the project will yield to society as well as to the individual or organization responsible for execution. The prices used in the analysis should be such as to indicate the cost and benefit of the project to society. Only then will the resultant calculation indicate the true economic return on a particular project so that it can be compared with the general economic rate of return that one would normally expect in the country in question—in whatever sector the investment might be made.

But often there is need to go beyond the generalized range of alternative uses for money to delve deeply into specific alternative projects and programs that may suggest themselves when a little imagination is applied. Many engineering reports handle this part of the job rather superficially. Consideration of too many alternatives is, of course, a waste of time and money. The line has to be drawn somewhere. But now it is sometimes drawn beneath one single course of action that the engineers have selected as “best.” Engineers should consider—and present in reports—at least the main alternatives in each instance. They should explain the different implications
of each, in terms of capital required, employment needed, space, time, etc. This is essential if the decision makers are to be given a real opportunity to choose.

The Search for Alternatives

Ironic as it may seem, the first task of experts called in to appraise a project should be to ask whether the need for the whole scheme could not be totally eliminated by undertaking some other less costly course of development. If there is a proposal for a new power station, consider first whether the present one could not be used more intensively by stimulating off-peak demand. If there is an idea of opening up a new area of the country by constructing new roads, harbors, and so on, ask whether these might be given up in favor of intensifying the use of existing land, transport, power, and other facilities. Or should an attempt be made to divert prospective growth of demand away from an already developed area to another area? Should a major agricultural project, readily analyzable but costly, be deferred in favor of a crush program to persuade farmers in existing agricultural areas to use improved seeds, better cultivation practices, more fertilizer, and more pesticide? Could transport requirements be reduced by establishing processing facilities at the site of raw material production? Again, in the field of transport, is physical displacement essential or would the transport problem be adequately solved by expanding the electricity supply network or the area's communication system? Would some reorganization of industrial land-use reduce the need for expansion of communications and transport facilities and of power generating capacity? All these questions and many similar ones merit careful investigation not only to determine the real need for investment but also to bring to light the full effects which each alternative may have on developments over the long run in other sectors. Economists call these effects "external," to indicate that they do not bring any immediate change in costs or revenues to the organization undertaking the project, but that they do cause increases (or decreases) in costs and returns of other organizations and individuals.

This comparison of objectives is not a simple job that can easily be performed and forgotten while work proceeds more deeply on comparison of techniques. For any specific investment tends to be highly interdependent with developments in other fields and places. For instance, it may have a significant effect upon the way in which the pattern of demand subsequently develops. An investment in power or transport or large-scale manufacturing—chemicals or mechanical engineering, for instance—tends to generate needs for further investments in the same field and in other fields. This is indeed one of the main processes of economic growth. The greater availability of cheap power may, of course, have little attractive effect in circumstances where there are too many other factors, unrelated to price, inhibiting industrial development; but equally, the prospective growth of demand for power may be so seriously underestimated that within a short time costly additions to the original investment become necessary. Substantial miscalculations of the prospective growth in demand can have such serious effects that it might result in the adoption of an inappropriate pattern of investment. Roads, for instance, once built, tend to draw traffic to them-
Economists and Engineers

selves; their very existence may encourage people to make some journeys that would otherwise have seemed too bothersome. Sometimes highways have been designed and built without sufficient attention to the traffic they were likely to attract in this way. When they have proven too small or the approach roads become too congested, costly additions have had to be made. Sometimes a whole series of such costly additions has become necessary. Had the long-run traffic build-up been correctly forecast from the start another form of transport, perhaps a railway, might in some instances have been preferable from the economic point of view.

Development by Stages

While projects should be considered together with all the likely expansion and developments in other fields which may result from their initial construction, it is equally necessary to consider the development of projects in stages. It has often happened that a long road, a large power plant, a steel mill, an irrigation system have been built at one time even though it would have been better to stage the

"Objectives, standards, design criteria, technical coefficients, economic coefficients, 'normal' growth rates—all have to be re-evaluated for application to a particular developing country."

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development over a number of years in line with the gradual build-up of demand.

**Long-Term Programs**

This points up the relationship of many projects—and especially public works projects—with long-term regional programs. Of course it is possible to go along doing many individual projects, each serving their own purpose, as and when they become obvious. Power is needed and the river is there, so build a dam and install a powerhouse. Later, when other needs appear, raise the dam for greater storage or provide adjuncts to it. But, as has often been indicated by my closest colleagues in the World Bank when we discuss large river basin projects, the sum of the results from this type of procedure is usually a good deal less valuable than those obtainable by careful comprehensive programing, with full consideration from the start of the alternative directions possible.

If, then, engineers are to meet the demands that the less developed countries will be putting upon them, they must give increased attention to the making of balanced long-run assessments of alternative courses of action. At present, they are not giving enough attention to economic considerations. Men schooled in the engineering disciplines often take too restricted a view of the possibilities for economic choice. Economists, who are trained to keep in mind the wide scope for choice—among ends as well as means—that nature provides us, are too little schooled in the technical aspects of evaluating projects. The addition of a few economists or a senior economic advisor to an engineering team is not an entirely adequate solution to the problem; any economist who has had contact with project work is acutely aware of the difficulties of communication between engineers and economists. Yet what is needed is continuous and close communication throughout the successive stages of preparation of a project.

If economists and engineers are to make this communication truly fruitful then they must be more critical of one another’s work and at the same time more tolerant of one another’s criticism. Statistical manipulations—benefit-cost ratios, response rates, consumption and production functions, etc.—are a convenient common language. But this language should never be used without an acute awareness of the lesson drawn from the history of economic development by one well-known policymaker—that “an active response to an unpromising technical economic setting may produce a better result than a sluggish or complacent response to a more promising setting.”
IFC: An Expanded Role for Venture Capital

David Grenier

The International Finance Corporation (or IFC, as it is generally known) is a member of the World Bank Group, sharing the same aims, although its operations are different from those of the Bank and the International Development Association. IFC’s business is to invest—and encourage others to invest—in private enterprise in the developing countries. Unlike the Bank or IDA, IFC provides risk financing, putting up equity as well as long-term loan capital and operating without government guarantee. Now that IFC is able to borrow up to $400 million from the World Bank, new prospects for an even more rapid expansion of its operations are opening up.

Within the family of institutions known as the World Bank Group, a notable feature in recent years has been the expansion of the International Finance Corporation (IFC). This development is evident in a number of areas: the rising level of IFC’s investment operations, the increase in its capital resources, and the growth of its responsibilities within the Group. The very fact of the existence of an institution such as IFC...
indicates an unusual consensus on the part of some 83 member governments concerning the need to encourage private enterprise and private investment in the developing areas. The growth of IFC indicates how this broad objective can be furthered by an intergovernmental organization which provides risk financing on terms related to the going rate for private capital.

When IFC was established in July 1956 as an affiliate of the World Bank, its role was conceived as a distinct one. To supplement the work of the Bank, IFC was intended to help finance private enterprises, in association with private investors and management; to assist in developing local capital markets; and to encourage the international flow of private capital. Unlike the Bank, IFC was set up to deal exclusively with the private sector and to operate without any kind of government guarantee. Unlike the Bank, too, the most significant yardsticks of IFC's operations were to be the extent to which it could act as a catalyst in stimulating other investment as well as its ability to revolve its own funds by selling off parts of its investments to other investors.

Nevertheless, IFC came into existence with two major handicaps. Its own share capital resources were comparatively limited. In addition, under its original Articles of Agreement, IFC was restricted from providing equity financing, even though it was expected to make loans with equity features, such as the right to participate in the profits of an enterprise. Experience showed that these restrictions limited IFC's ability to meet the needs of private enterprises in the developing countries. As a result, IFC's Articles have twice been amended: in 1961 to permit the Corporation to invest in equities, and in 1965 to permit IFC to supplement its own share capital of approximately $100 million by borrowing from the Bank. These changes have been reflected in the scope of IFC's operations. It has emerged as the investment banking arm of the Bank Group. It takes minority equity participations, carries out stand-by and underwriting arrangements, and develops the kind of continuing relationship with clients characteristic of a private investment banker. It has also become the main point of contact between the Bank Group and private enterprise in the fields of industry, mining, and development finance companies. In each of these areas, IFC is responsible for ap-

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praising and supervising all projects submitted to the Group, irrespective of which member of the Group is to provide the financing.

Greater Flexibility

Over a period of time, IFC has become more flexible in the kinds and amounts of financing it will provide as well as in the range of enterprises it is prepared to finance. So far, the Corporation has confined its attention almost exclusively to the manufacturing industry: the bulk of the commitments of more than $200 million made to date by IFC have been to iron and steel, pulp and paper, textile, cement, and fertilizer companies. Recently, however, IFC has helped to finance ventures as diverse as an electricity utility company, a tourism project, and enterprises related directly to agriculture in the form of grain storage and livestock raising. In all, IFC has now made investments in enterprises located in 36 countries. While Latin America remains the region where IFC has made by far its largest over-all commitment—reflecting the range of private investment opportunities available in such countries as Brazil, Colombia, and Mexico—the Corporation has more recently extended its interests in Africa and Asia.

Since the removal of the charter restriction on equity investment, the normal method of IFC financing has become a blend of equity and long-term loan funds or, alternatively, straight equity. Less frequently, IFC may undertake financing through the purchase of convertible debentures or through a loan with a stock option attached. Only in two exceptional cases has IFC provided loan financing without equity or an equity feature.

The size and type of investment originally made by IFC were dictated not only by the limited availability of suitable projects but also by the limited size of its own resources. This position has changed now that substantially larger resources are available to IFC in the form of World Bank funds. Following the completion of amendments to the Articles of Agreement of the Bank and IFC in late 1965, the Corporation is at present permitted to supplement its own share capital and reserve of approximately $130 million by borrowing up to $400 million from the Bank. An initial Bank loan of $100 million to IFC was in fact approved last October, for use by IFC in the
lending part of its investment operations. As a consequence, the upper limit on the size of the individual commitment IFC is prepared to make has been raised. Up to last year, the largest single commitment undertaken by IFC was of the order of $6 million. The maximum amount which IFC would ordinarily consider committing on its own account to a single enterprise is now $20 million. Reflecting the increased resources available from the Bank, IFC has in recent months made commitments of about $10-12 million, and others of similar size are now in prospect.

A Distinctive Role

IFC's position within the Bank Group is a distinctive one. Unlike the Bank and the International Development Association, which are mainly concerned with major infrastructure projects in the public sector, IFC's operations are concerned exclusively with the private sector, chiefly in industry. While the Bank and IDA are lending agencies, IFC is in a position to provide risk financing in the form of equity as well as long-term loan capital. In contrast to the Bank's conventional lending rate and the "soft" terms of IDA credits, the terms of IFC financing are intended to be in line as far as possible with the expectations of private investors and designed specifically to attract their participation in IFC investments.

In examining investment proposals, IFC takes into account such factors as economic priority and potential profitability and tries to ensure that the presence of IFC is likely to make a constructive contribution. There are other factors to consider. The kinds of situations in which IFC is prepared to act are those where new money is needed; where sufficient private capital is not available on reasonable terms; where the sponsors, together with other investors, are prepared to make a meaningful contribution to the risk capital requirements; and where there is room for participation by
local investors. It is through its attention to such criteria that IFC establishes its function as a development financing agency. At the same time, the Corporation takes much the same kind of position as would a private investor, in terms of attempting to determine the technical soundness of a project, the availability of markets for the company's product or products, the competence and experience of the management, and the adequacy of the financial plan.

In the broadest possible sense, IFC tends to be involved in projects which, but for its catalytic role, might not go ahead. This in turn reflects the fact that IFC is in business to be more venturesome and take somewhat larger risks, whether business or political, than the market would be prepared to absorb. Since no two IFC investments are identical, the exact terms of IFC's participation in a project vary considerably. In some instances, IFC may be needed to put up part of the "first money", to

Lumber is about to enter the treating kiln at the Wood Preserving Division of the Atlantic, Gulf and Pacific Company in Manila in the Philippines. The firm has been financed by the Private Development Corporation of the Philippines, which the World Bank and IFC has assisted.
Expansion of the cattle operations of Industria Ganadera Colombiana, S.A., at Medellin, Colombia, was partly financed by an IFC investment.

get a project going and to give confidence to the private investors taking part; in other situations, IFC may be required to put up the “last money” needed to fill a gap in a financial plan.

Often, IFC may also be needed to provide financial entrepreneurship not available from other sources. This may involve putting together the kind of investment package available to the entrepreneur in the industrialized countries from specialists who can provide technical know-how, mobilize equity and long-term loan funds, recommend marketing and distribution arrangements, and establish effective management. IFC is in a position to provide some of these services but it does not provide or participate in management and is not a know-how partner, so that the actual sponsorship and technology for a project must come from private investors. Many of the enterprises in which IFC has invested are in fact joint ventures between local and foreign investors, with the foreign partner providing technical, managerial, and administrative skills and the local partner contributing knowledge of local market conditions and experience in handling relations with labor and government. In this kind of situation, IFC can sometimes act as a third party in helping to bring prospective partners together.

Developing Capital Markets

The greater emphasis today on IFC’s role in developing local capital markets and mobilizing local resources is seen in its activities as an underwriter of public offerings of securities. In this way, IFC can help to obtain some degree of public participation in the ownership of family-held or closely-held enterprises, which
tend to be the norm in developing countries. The underwriting technique can also be used to help expand the ownership base of larger enterprises needing additional equity in order to increase their borrowing capacity. IFC has now made stand-by or underwriting commitments totaling $25 million to enterprises in some 10 countries, most notably Mexico, where the Corporation has on three occasions helped to underwrite securities offered by the largest shareholder-owned steel company in the country, Compania Fundidora de Fierro y Acero de Monterrey S.A. IFC's partner in each of these operations was the subsidiary of a leading Mexican bank, with financial institutions in the United States and Europe acting as subunderwriters for a substantial part of the IFC commitment.

IFC's function as an underwriter can be traced through its relationship with Fundidora. The initial IFC commitment, made in 1962, involved participation in a $4 million stock offering, together with a direct subscription to shares of the company. The capacity of the Mexican market to absorb the offering was limited, and only about 60 per cent of the issue was placed with shareholders during the underwriting period, the remainder being sold over the course of the following months. In 1964, IFC took part in a much larger transaction, involving the underwriting of a $12.2 million stock offering, this time with increased participation on the Mexican side. Despite the size of the offering, the largest ever to be made by a private enterprise in Mexico, the issue was nearly 100 per cent subscribed. Last year, IFC took part in a further underwriting of stock in the amount of $7.2 million, this time in conjunction with a private placement of $6 million of convertible debentures, denominated in U.S. dollars, the first paper of this kind to be issued by the company. Since 1962, these underwriting operations have helped to broaden the capacity of the Mexican capital market. The ownership of the company has increased from some 700 shareholders in 1962 to over 2,000 shareholders today. Finally, the recent private placement of convertible debentures will facilitate the company's recourse to raising funds outside Mexico.

Development Finance Companies

Within the last five years, one of the major extensions of IFC's operations has been in respect to development finance companies. These are institutions controlled by private shareholders, both domestic and foreign, and able to act as a focal point for growth of the private sector. They provide equity and medium and long-term loan capital to industry and other private enterprise, carry out underwriting operations, help to promote and finance new enterprises, and otherwise assist in developing capital markets. The Bank Group has been an important external source of funds for some 25 development finance companies of this kind in 21 countries, providing a total of over $560 million in capital resources. In turn, the development finance companies have represented a useful channel for providing finance for smaller or medium-sized enterprises to which the Group could not give effective direct assistance. Since 1962, IFC has become a shareholder in 17 development finance companies in 15 countries, involving commitments totaling nearly $19 million. On a number of occasions, IFC has joined with development finance companies in financing projects which required more capital than the companies alone could provide.
Apart from supplying share capital, IFC has assisted development finance companies in a variety of ways. In several countries, the Corporation has taken the lead in helping to reorganize and expand existing institutions, as in Finland, Morocco, Malaysia, Nigeria, and Thailand. The most recent example of this type of operation was in Tunisia, where IFC was responsible for helping to reorganize an existing government-owned institution, the Société Nationale d'Investissement (SNI). As a result of these arrangements, the World Bank last year agreed to make SNI a loan of $5 million, with IFC making an accompanying share investment. In addition, IFC was instrumental in securing the participation of French, German, Italian, and Swedish financial institutions as shareholders of SNI. As a consequence of the reorganization, SNI is now under private control.

IFC has also been prepared to assist in establishing new development finance companies where gaps in the local capital market have indicated a substantial need for a shareholder-owned institution, where the volume of business available has offered the prospect of profitable operation and where the government has been prepared to provide support. Examples of IFC's operations in this respect include institutions established in the Philippines and Venezuela. Experience over the years has indicated that while development finance companies of the kind associated with the Bank Group can operate profitably in the larger countries and are an effective medium for assisting medium-scale industry, they are not as well suited to meeting the needs of smaller countries where the potential market is smaller, nor are they a suitable medium for financing small-scale industry or handicrafts.

Assessing IFC's Operation

In making an interim assessment of IFC's operations, a number of criteria can be applied. One is IFC's function in rounding out more substantial investments by others. So far, IFC has taken part in financing industrial projects involving a total capital cost of approximately $895 million. IFC's exposure in these projects (net of cancellations, terminations, and participations by private investors in the original commitments) amounted to $150 million, indicating that on average every $1 committed by IFC has been matched by commitments of $5 by other investors. Another measure of IFC's operations is the fact that the Corporation has been able to turn over a total of approximately $57 million of its investment and underwriting commitments to other investors, or over one-fourth of total IFC commitments. This reflects in large part the extent to which IFC has been able to sell parts of its investments to a wide range of financial institutions in North America, Europe, and the Middle East. Finally, of the 23 IFC investments closed out so far, 21 have been closed out at a profit. Taking into account losses incurred in two instances, the average annual return on these investments has been approximately 12.15 per cent.

Much of the growth of IFC's operations is recent. This is reflected in results for the fiscal year ended June 30, 1966, during which the Corporation's commitments of $35.6 million were more than 40 per cent greater than in any previous year. This figure is likely to be exceeded during the current fiscal year: in the
first nine months alone, commitments announced amounted to $32.3 million. These results indicate the major changes now taking place in IFC operations, not only in terms of the number of commitments but also the kind and size of commitments. Several factors are involved. Some, such as tight money conditions in the major capital markets of the world, are not likely to continue indefinitely. Of greater long-term relevance are the growth of IFC's own experience and capability; a larger flow of projects, reflecting greater interest on the part of outside investors in the prospects for the manufacturing industries in the developing countries; and the growing sophistication of the industrial structure of many of the larger countries in the developing areas, as evidenced by the establishment of new, capital intensive industries.

With these factors at work, the initial World Bank loan of $100 million to IFC will make it possible for the Corporation to sustain and expand its present level of operations and make larger individual commitments at a time when its own uncommitted funds have been virtually exhausted. Examples of the new dimension of operations open to IFC are the recent $12 million equity and loan financing of Manila Electric Company (MERALCO), the leading private electric power utility in the Philippines, and the $10.7 million financing of Ultrafertil S.A., a new company formed as a joint venture by U.S. and Brazilian investors to establish a $70 million fertilizer manufacturing and distribution complex in Brazil. Illustrating the trend toward greater diversification in IFC's operations is its first commitment in the field of tourism. The IFC participation is in a $6.7 million program to finance an international-class hotel in Nairobi, the capital city of Kenya, and new tourist facilities in the national game parks, which are Kenya's chief tourist attraction. Here the guiding considerations included the economic priority of tourism as the country's second largest source of foreign exchange; the prospects of investing in an enterprise with experienced sponsorship and management; and the knowledge that the construction of new tourist facilities which IFC is assisting will be supported by investment by others in related infrastructure, for example, all-weather access roads in the national parks.

The Prospects

The prospects before IFC are in many ways more attractive than at any time in the past. Of necessity, much will depend on a continuing flow of projects suitable for IFC financing and, more generally, on continued growth of private sector activity and private capital flows to the developing countries. The need for substantial investment in manufacturing and other industry is apparent in a number of areas: most urgently, perhaps, in the expansion of fertilizer production, an area in which IFC has taken the lead on behalf of the Bank Group in discussions with private investors. Nevertheless, there are strong and continuing social, political, and emotional issues involved in the role of private enterprise and private capital in economic development. On the one hand, there are real doubts on the part of many private investors as to whether the risks incurred in the developing countries are in line with the potential returns, in terms of market penetration and growth or actual return on capital. On the other hand, there are strong differences of opinion in some developing countries regarding
the priority to be accorded the private sector. These differences of opinion are compounded by fears of foreign ownership of resources, concern about the balance of payments impact of repatriating dividends and interest, and other factors. Despite the progress of the last decade, there clearly remains a wide gap to bridge in reconciling the expectations of the private foreign investor with the aspirations of the host country.

Survey Mission Reports from the World Bank

Since 1949 the World Bank has sent more than a score of economic survey missions to as many different countries. Organized at the request of governments, the missions make on-the-scene surveys of the problems and potential for development in the country being studied, and they make recommendations to assist the government in shaping long-term development programs. Each mission’s final report, in English, is published as a book by The Johns Hopkins Press. Reports on the following countries are available: Kenya, Morocco, Territory of Papua and New Guinea, Spain, Uganda, Tanganyika, and Venezuela, US$8.50 each; Libya, Jordan, Malaya, and Syria, US$7.50 each; Kuwait, US$6.50; Thailand, US$6.00.

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This book, which is subtitled “The West and the Transformation of Asia, Africa, and Latin America,” is a study based upon economics, history, theology, anthropology, sociology, and psychoanalytic theory. So interdisciplinary is it, indeed, that it is to some extent extradisciplinary; as the author notes, it is “not only nearly devoid of scholarly references; it is also full of unscholarly generalizations.” The result is a book that is at once humane and skeptical, penetrating, original, and literate.

The book is original in that it opens with an account not of the attitudes and expectations of the developing world in regard to the developed, but of Western man’s attitudes and expectations in regard to his own environment—attitudes and expectations that are ineluctably extended to the developing world.

To this world the author then turns, analyzing the traditional and transitional societies in the light of his own experience within a sociological and psychological framework derived from the work of, among others, Max Weber, Talcott Parsons, and Benjamin Nelson. He deals with development strategies in Asia and Africa and their limitations, under such headings as the relation of political and economic development, the characteristics of transitional political regimes, and the economic implications of development strategies. Turning to Latin America he plunges intrepidly into “The Iberian Background,” the “Structure and Personality Types of Latin American Society,” and “The Dramatic Design of Latin American Culture.” He then turns to the political and economic modernization of the subcontinent.

In the course of this world tour Dr. Geiger touches upon such subjects as messianic cults, the sociological implications of Zen Buddhism, the tariff protection of infant industries, “African Socialism,” Latin American landholding systems, and the influence of medieval scholasticism upon the development of Latin American culture. The reader who travels with him may find himself at the end a little short of breath, but the author himself is not. Like an experienced guide, he is at ease on his chosen route, which is planned to give the reader both particular insights and a general view which could not so easily have been provided in any other way.

One of Dr. Geiger’s insights seems especially penetrating and important. During the last few years a considerable number of books and articles have appeared in which Americans and other Westerners have been chided for their brash and insensitive attitudes to the people of the developing countries. The authors of such books and articles have often had long experience in developing countries. They form a highly civilized and perceptive group, and as individuals working in developing countries they may be very effective, if only because they have the will, imagination, and sympathy to break through the barriers that divide their colleagues alike from the local elite and from the traditional society.
The insight that I have referred to in *The Conflicted Relationship* as being especially penetrating is the way in which Dr. Geiger reveals, without moralizing about, the gulf which divides these somewhat exotic characters who are at ease in both worlds from their own fellow citizens, the Westerners-in-the-street who vote for or against development aid. He cites public opinion polls which suggest that Americans (who in this context may be allowed to represent the West) care less and less about helping the poor countries; against 70 per cent favoring foreign aid 15 years ago, only 50 per cent do so now. He argues—or it might be truer to state that he suggests—that this is partly because Americans are disappointed in the results of aid already given; the developing countries seem to them to have been ineffective, purposeless, lazy, so unable as to appear positively unwilling to change conditions which they yet proclaim to be intolerable.

No doubt such American attitudes are deeply provincial; and that indeed is Dr. Geiger’s point—that in relation to the world at large, American attitudes are both deep and provincial—to just about the same degree that the tenets of some Eastern religions are both deep and provincial. The holders of each appear to their opposite numbers as completely incomprehensible and perverse. American feelings about American values, however, run so deep (Dr. Geiger argues) that “the United States would not be providing aid on a meaningful scale if this activity did not also constitute a major way of expressing the American will to action, positivistic conviction of mastery over nature and society, and senses of mission and guilt.” Only if we understand the religious quality of this commitment and its potency can we see through what the author calls “the rhetoric of development” and effectively produce and manage development aid. That this will not be an easy task we all appreciate, and the author’s stern view may not be unduly pessimistic; yet it seems curious that a spirit of enquiry that ranges so widely should be unconcerned with the role or even the potential of such international institutions as the IMF and the World Bank.

Dr. Geiger is addressing himself principally to the Western, above all to the American, policymakers of aid; but it is of wider interest that in doing so he gives the screw of sophistication another turn in asking from the developing world that it should try more perceptively to understand to what an extent the transitional peasants of the developed world, for all their cars and refrigerators, are still the prisoners of traditional beliefs; how many of us, as inheritors of the Puritan ethic, are in the depths of our being the followers of such great religious teachers as Calvin and Knox and of their exceedingly potent and tenacious, if not always amiable, doctrine of “effective good works.” In development aid as elsewhere there has to be a degree of recognition of the element in our behavior of which it must be said that, God helping us, we can do no other.

J.D. Scott


THIS IS AT ONCE a book on the practical problems of planning in a developing
country, an essay in economic theory, and a manual for economic advisors. Many of the divergencies between theory and practice are set out clearly, examples of solutions to planning in the absence of reliable information are given, and theoretical problems issuing from the economic peculiarities of a developing economy are met squarely. The latter, in particular, is an act of courage, since much of present-day theoretical economics is shot through with enormous logical complexities expressed in a difficult mathematical lingo, and its understanding requires powerful methodological and analytical abilities, as well as sure instinct.

The author applies his skills to three main topics: the rationalization of planning methods in a framework that can be subject to rigorous economic analysis; the utilization of national accounts as a planning tool (a discussion which has the flavor of a personal diary); and the analysis of appropriate investment criteria.

Dr. Stolper has built his arguments on these topics around the experience he gained in Nigeria in 1960-62 as head of the Economic Planning Unit.

Nigeria is the main subject matter of the remaining parts of this essay: a discussion of money and banking, a presentation of the author's ideas on the relationship between business and government, and an analysis of resource allocation as the central theme of a developing economy.

It is a measure of the author's success that the reader, unfamiliar with the Nigerian case, is provoked less into looking into the peculiarities of the country as into the fundamental theoretical and policy arguments—applicable to any country—developed in this book.

This being a provocative book, there is much one can disagree with. The author's attempt to show that profitability is the criterion on which should be based project, sector, and economy-wide decisions will not convince many other economists.

There will also be doubt as to Stolper's refutation of import substitution as an investment criterion. This is done by comparing the logic of import substitution with that of profit maximization; the comparison, however, is not necessarily correct, since one can always devise an import substitution strategy within a profit maximization framework, wherein the relevant prices have been established at the outset.

Yet, Stolper's critique of shadow prices is convincing and timely. The resulting contradiction is certainly not the author's fault, but a poignant demonstration of the difficulties of modern economics. These difficulties, this book shows, have a significant bearing on day-to-day actions and policies. One of the merits of the author, who inclines toward neoclassical economics, is that he nevertheless does so with a refreshing skepticism, showing the value of a pragmatic and thoughtful approach.

The book is accompanied by an input-output analysis of the Nigerian economy, a brilliant effort by N. G. Carter showing the possibilities of this tool for planning purposes.

Paolo Leon


It IS NOT an easy task to explain why, after all the destruction of World War II, West Germany developed into one of the most dy-
namic industrial nations in Europe. Certainly, such a task is beyond the scope of this mono-
graph, but the author, Hans-Joachim Arndt, gives his reader many insights into the com-
plexities of the “German Economic Miracle.”

Written from a multidisciplinary point of view, the book, *West Germany, Politics of Non-Planning*, examines the various attitudes and influences which have created the “Social Market” system. The first half of Dr. Arndt’s text provides a stimulating description of Germany’s early experiences with governmental planning. Yet, planning in the Federal Republic of Germany is haunted by two ghosts—memories of the Weimar Republic’s failure to maintain economic stability, and the grim policies of “planned scarcity” pursued by the National Socialist Third Reich. These specters seem to be embedded in the nation’s contemporary economic doctrine, which, says the author, “emphatically regards itself as anti-planning.”

In contrast, the second half of the study examines a vast array of groups and institutions which make up Germany’s social fabric. Special attention is given to analyzing the attitudes and values expressed by different “generations” within the private sector’s managerial class. From this framework, similarities and differences between the various age groups are uncovered, as well as broad patterns of human interaction. The reader may be somewhat disappointed with the description of the private banking system, for little is said about the function and role of the corporation supervisory boards. With the wide representation of the private banks on these boards, collaboration on a broad scale between varied business interests is made possible. Such widespread consultation has many macro-planning implications.

In spite of minor inadequacies, however, this is a welcome addition to the existing paperbacks in the National Planning Series, throwing much light upon contemporary arguments over the future course of Germany’s economic policy.

Jeffrey H. Dennis


The “Chronique Sociale de France”, a well-known French periodical, devoted, at the end of 1966, a special issue to the international monetary reform, or, rather, to what it called “the war of the currencies.” Various authors, including Professors Bye, Breier, F.V. Meyer, and Triffin, attempt to describe the problem of international liquidity and present various solutions. No informed reader would agree with all the statements printed in this special issue, but he would also recognize that by reading it the uninformed reader will receive instruction which will help him to find a path out of the money muddle.

J. van der Mensbrugghe
Finance and Development does not attempt to evaluate books or contributions thereto by members of the staff of the International Monetary Fund or the World Bank, but notes them as likely to be of interest to its readers.


Mr. Kamarck's latest book discusses African development and in general estimates just how successful the nations on that continent may be in handling their problems in the struggle for economic prosperity. The author, who is Director of the Economics Department of the World Bank, suggests some ways to speed up the pace of development. One would be to invest more international resources in research on the tropics. Mr. Kamarck also suggests that new development techniques may be needed, such as the consideration of a "generation-long contract between an international aid agency and the recipient country, through which the necessary transformation of the country's economy from top to bottom could be systematically and thoroughly carried out."


This book constitutes the report of an International Conference in England held jointly by the Ditchley Foundation and of the Overseas Development Institute in the summer of 1966. It contains papers on aid administration at home and overseas, terms and conditions of aid, the role of technical systems, the coordination of aid, measures to ensure the effective use of aid, and motives and objectives of aid. The paper on the coordination of aid was written by Mr. Michael Hoffman of the World Bank.
Views and Comments

From a speech by Dr. Otmar Emminger, Member of the Board of Governors of the Deutsche Bundesbank, delivered at the European Luncheon Club of the British Council of the European Movement, London, on January 25.

In September 1965 the Finance Ministers and Central Bank Governors of the ten most important industrial countries, the so-called Group of Ten, asked their Deputies to determine 'what basis of agreement can be reached on improvements needed in the international monetary system, including arrangements for the future creation of reserve assets, as and when needed.'

In the sixteen months that have elapsed since then, the Group of Ten has gone a long way towards finding a possible basis for the future evolution of the international monetary system—although there has been no lack of difficulties and setbacks on the way.

"If we want to be realistic, we have to envisage the continuance of a large volume of dollar and sterling reserves into the future, and also into a new international reserve system comprising some deliberately created new reserve asset. This poses the problem of co-existence between currency reserves and other reserve assets, and with it the problem of the stability of such a system. This problem could be solved, or at least greatly eased, by establishing a reserve system whereby a new reserve asset would be provided not only in order to add to existing international liquidity in case of need, but also in order to compensate for any shrinking of international liquidity resulting from a decline in currency reserves.

“We may also imagine more pragmatic solutions. There are already now some features in our present system which point in this direction. One is the gradual assumption of a sort of collective responsibility of a group of strong countries for fluctuations in reserve currency holdings, primarily those fluctuations whose origin lies not in the balance of payments of the reserve center, but in outside factors. I refer to the network of swap facilities up to a limit of $4.5 billion that exist between the American Federal Reserve System and a number of other central banks. Another example is the swap arrangements conducted in June 1966 by a number of central banks with the Bank of England in support of the pound sterling, arrangements which are directly related to movements in the British reserves arising out of fluctuations in the sterling balances. I refer also to the General Arrangements to Borrow (GAB) with the IMF which have set up a currency pool of $6 billion in order to compensate, in case of need, large-scale movements of funds between the major countries. These General Arrangements to Borrow were really the origin of the Group of Ten.

“As a counterpart to this emerging common responsibility of a group of countries for the stability of our international reserve system, there is the system of ‘multilateral surveillance’ of our reserve system, as exercised, at present, jointly by the Central Bank Governors assem-
bled at the regular Basle meetings and by the Working Party 3 of the OECD, which in essence is an affiliate of the Group of Ten. This ‘multilateral surveillance’ is intended to cover all the major aspects of reserve creation and reserve policies, and it could easily be developed, in a pragmatic and flexible way, so as to shield our reserve currency system from the risks of instability arising out of the coexistence of various kinds of reserve instruments.

“These are admittedly very pragmatic solutions; or rather embryonic beginnings which over time may lead to a sort of collective management of our international reserve system. As the famous English financier, Walter Bagehot, said, scarcely a hundred years ago: ‘Money does not manage itself.’ It must, indeed, be managed by human intelligence and foresight. President Kennedy, a few months before his tragic death, expressed this same thought in a famous speech in Frankfurt, my home town, when he said: ‘The great free nations of the world must take control of our monetary problems if these problems are not to take control of us.’”

From a speech by Henry H. Fowler, Secretary of the United States Treasury, delivered at the Monetary Conference of the American Bankers Association, at Pebble Beach, California, on March 17.

THE U. S. balance of payments, and programs designed to affect it, must be viewed in several perspectives.

“Whether enjoying surpluses or coping with deficits, the U. S. balance of payments adjustment process has become a key element in the political, military, diplomatic and international economic policies of the United States and of major concern to the world at large. This is true for several reasons:

First, the key role of the United States in free world security, trade, exchange and economic development;

Second, the important role of United States generated capital, public and private, and the business activity that flows from it, in many countries outside the United States;

Third, the special position of the dollar as a reserve and transaction currency on a worldwide scale, making it the keystone of the international monetary system on which free world trade and development depend.

“Another perspective is the long series of deficits in U. S. payments. Beginning in 1958, rising claims upon our gold stock signaled the end of the world's almost total postwar dependence upon the dollar, the increasing strength, desirability and convertibility of other currencies, and the availability of sufficient dollars in foreign official holdings to permit a shift in the mix of monetary reserves in favor of gold.

“The series of heavy deficits in the three years 1958-60, averaging $3.7 billion per year, on the ‘liquidity’ basis, and accompanied by gold outflows averaging nearly $1.7 billion per year, signaled the need for a program to bring U.S. payments into substantial equilibrium.

“Beginning in 1961 the U. S. Government initiated a series of measures to reduce the deficit without disrupting trade and travel, and without abandoning its key role in free world security and development.
"This effort was thrown off target by at least four developments, each transitory and somewhat unpredictable:

1. The Berlin crises with the necessary force build-up in 1961-62;
2. A sharp upswing in the levels of private foreign borrowing in 1962 and 1963;
3. A sharp increase in private capital outflows between 1962 and 1964;
4. The rapid increase in military foreign exchange costs in late 1965 and in 1966 resulting from stepped-up military operations in Southeast Asia.

"Despite these adverse developments the deficit, measured on a liquidity basis, fell from the average of $3.7 billion in the years 1958-60 to an average of $2.5 billion in the years 1961 through 1964. In 1965 and 1966 it was further reduced to $1.3 billion and $1.4 billion, respectively. This occurred despite an increase during that time in net military expenditures outside the United States because of Viet-Nam costs exceeding $950 million and a decrease in our trade surplus from the peak level of 1964 by $1.9 billion in 1965 and by $3 billion in 1966.

"On the official settlements basis, there was an average deficit of $0.5 billion in 1965-66, compared to $2.2 billion in the preceding five years.

"I am not going to dwell today on the short-term or temporary measures being used to restrain or moderate private capital flows. We are relying on them to keep our deficit under control during the period of our special commitments in Southeast Asia, the period required to realize the benefits of our long-range program.

"There is already too much emphasis in public discussion on this holding operation, tending to obscure both the existence and strategy of the long-range program we are employing in the balance of payments adjustment process.

"That program—for coming into, and maintaining, a sustainable equilibrium—is essentially a long-term one, aimed at solving the problem

—not by a resort to restrictions or withdrawals that are damaging to free world security, trade, exchange and development

—but by making use of this nation's unexampled economic strength in the context from which that strength has been derived: competitive free enterprise.

"The success of this strategy and program, it should be understood by all concerned here and in other countries, depends importantly on (1) an open, competitive and cooperative international economic order and (2) substantially strengthened multilateral arrangements to ensure the financial viability of programs for free world security and aid to developing nations.

"I continue to find it necessary and relevant to emphasize to my colleagues from other countries that the way in which this nation handles its balance of payments problem depends in large measure on the cooperation it receives from other countries in the process, and upon the way in which other important financial nations act in dealing with their own domestic and international monetary problems. I find it also necessary to emphasize that this cooperation is not a matter of helping the U. S. deal with its problem but a matter of enabling
the United States to deal with its problem without: undermining the international monetary system, subjecting that system, by unilateral action, to radical and undesirable change; or withdrawing from commitments involving the security and development of others.

"The United States' long-term balance of payments objective—stated most simply—is to reach and sustain the degree of equilibrium necessary to preserve confidence in the stability of the dollar, both as a transaction and as a reserve currency."


"CENTRAL BANK GOVERNORS, myself included, have for some long time been uttering warnings about the dangers of undue reliance by many countries on credit restraint and monetary policy. The reduction of interest rates all round is something which central bank governors earnestly desire. But no one can lower interest rates simply by ordaining that this shall be so. If it were attempted we should merely find, as a distinguished British economist said a few years ago, that having thrown interest rates out of the door they could not be prevented from coming back through the window.

"In this field, as elsewhere, it is no use suppressing the symptoms without tackling the disease. The level of interest rates reflects the facts of life—the over-all levels of demand in different countries; the rates of inflation; the pace of expansion of government expenditure; the balance in applying restraint between fiscal and monetary policies; the nature of the systems of taxation; the interrelations between different countries' balances of payments; world-wide trends in the supply of capital and the demand for it: the list, of course, is endless.

"There can be no simple answer to the question of how high any country's rates should be at a particular time. But if finance ministers wish to change the present situation, and indeed only they can do so, their most important contribution will be to change appropriately the balance of their internal policies and in particular to get government expenditure under proper control."

From a speech by P.C. Bhattacharyya, Governor of the Reserve Bank of India, delivered at the Conference on Industrial Development, Calcutta, on December 20, 1966.

"I SHOULD LIKE to say that the nature and character of the industrialization process in developing countries today are much different from those of the countries which developed during the nineteenth century. During that period, the industrialization process was gradual, dependent as it was on the evolution that took place in industrial technology. The costs of this gradual industrialization were much less as industries were less capital intensive than they are at present. Further, the resources for financing industrial development were partly available from the large agricultural sector, which experienced a pace of technical change and development more or less comparable to the industrial development in the United Kingdom. The rapid agricultural
development in countries like the United States of America, Canada, Sweden and Japan provided not only resources in the shape of a much-needed expansion in exports of agricultural commodities but also the markets for the industrial sector.

"In the developing countries today, none of these favorable factors prevail. Because of vast technological developments and the large size and indivisible character of investments in infrastructure, the costs of industrialization are much larger than they were during the gradual process of industrialization during the nineteenth century. Moreover, the possibilities of obtaining resources from agricultural expansion that existed during the nineteenth century are no longer there; in most of the developing countries, the agricultural sector has to be financed from resources obtained in the industrial sector. Again, unlike the nineteenth century, these countries are not in a position to tap markets for their industrial consumer goods in the other countries.

"The problems in the present-day developing countries are further aggravated because of the population explosion and the egalitarian pressures. With regard to both these factors, the situation during the nineteenth century was much more favorable for the process of industrial capital formation. Further, the nature and relative magnitude of international private capital flows during the nineteenth century were much more favorable.

"Thus in the present-day world, developing countries face a formidable combination of difficulties. In our case the position has become particularly difficult during the last four years or so when a combination of external factors has caused serious upsets."
Recent Activity

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL DEVELOPMENT ASSOCIATION
INTERNATIONAL FINANCE CORPORATION

Settlement of Investment Disputes

The Administrative Council of the International Centre for Settlement of Investment Disputes held its inaugural meeting in February 1967 and elected Mr. Aron Broches, General Counsel of the World Bank, as the Secretary-General of the Centre. Mr. Broches continues to be General Counsel of the Bank.

The International Centre was established as an autonomous international organization under the Convention on the Settlement of Investment Disputes Between States and Nationals of Other States which came into force on October 14, 1966. The Convention was sponsored by the Bank because of its belief that the creation of an institution especially designed to facilitate the settlement of investment disputes between States and foreign investors could be a major step toward promoting an atmosphere of mutual confidence and that adherence to the Convention would stimulate a larger flow of private international capital into those countries which wish to attract it. The Administrative Council consists of one representative of each State which has ratified the Convention; these so far number 28. Mr. George D. Woods, in his capacity as President of the World Bank, is Chairman of the Council.

World Bank Bond Issues

During the quarter under review, the Bank raised further funds through a private placement and a public offering of its bonds. In March 1967, it arranged the sale, entirely outside the United States, of a $100 million of 5% per cent two-year bonds. The sale, at par, was made by private placement with central banks and other governmental institutions in 43 countries and with one international organization. This represented a record number by nationality of participation for any World Bank bond issue.

In the same month, the Bank made a public offering of $250 million, 25-year 5% per cent bonds, due April 1, 1992, at 100% per cent to yield 5.35 per cent. This was the largest single issue the Bank has so far made.

Sweden Offers Sixth Special Contribution to IDA Resources

Sweden has offered, subject to parliamentary approval, a sixth special supplementary contribution of $5 million to IDA. Sweden's five earlier special supplementary contributions amounted to $23.1 million. These, together with its initial subscription, its contribution to the first general replenishment of IDA's funds, and the sixth special contribution, will bring Sweden's total payments to IDA to $53.2 million, or more than five times its original subscription. With the exception of Kuwait, Sweden is already the largest contributor to IDA on a per capita basis.
Consultative Group for Tunisia

The Consultative Group on development assistance to Tunisia met in Paris on March 16 and 17 under the chairmanship of the World Bank. The following countries were represented: Belgium, Canada, Denmark, Finland, France, Germany, Italy, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States. Representatives of the International Monetary Fund, of the European Investment Bank, and of the United Nations Development Program were present, as well as an observer from Austria. The Group discussed a report on the current economic position and the status of external debt of Tunisia prepared by the World Bank, an IMF report, and the Tunisian Government's economic budget. The Consultative Group heard a statement of H.E. Ben Salah, Minister for Planning and National Economy, and held an extensive exchange of views with the Minister and his associates on Tunisia's development problems and prospects. The Consultative Group reached a consensus that Tunisia's economy could usefully absorb continuous and substantial assistance from members of the Group, if provided on appropriate terms. It was tentatively agreed that the Group would hold the next meeting in early 1968.

Study of Suppliers' Credits

A study of the use of suppliers' credits and credit insurance conducted by the staff of the Bank at the request of the United Nations Conference on Trade and Development (UNCTAD) was transmitted to the United Nations in January. The study traces the growth of suppliers' credits as an important medium of international finance and examines the nature and causes of various problems which have arisen in their use, with special reference to effects on the debt situation of developing countries. The growing importance of suppliers' credits, as a large component of capital flow to developing countries, is made clear by the fact that at the end of 1965 these countries owed an estimated $7,000 million in this form. This represented over one sixth of the total external debt and a much higher proportion of the annual debt charges of the developing countries; these countries were paying more than $1,400 million a year in service charges on suppliers' credits, out of total debt payments of some $4,300 million. According to the study, the bulk of such debt was concentrated in Argentina, Brazil, Chile, Ghana, Korea, Mexico, Nigeria, Peru, the United Arab Republic, and Yugoslavia. The study describes both the positive contributions made by the use of suppliers' credits and the various excesses which have developed in the use of this form of finance, which in some cases have resulted in debt crises requiring the rescheduling of payments.

The study incorporates a series of recommendations for national and international action to help enhance the usefulness of suppliers' credits as an instrument of international finance, while avoiding debt crises and distortions in economic development resulting from excesses and abuses in their use.

Port Study in Nicaragua

The Government of Nicaragua and the Bank have signed an agreement providing for a feasibility study for the expansion of the Port of Corinto. The Bank will pay the foreign exchange costs of the study, estimated at...
$175,000, while the Government of Nicaragua will meet the local currency costs. The Anglo-French firm of LIVEST (Livsey and Henderson of London and Société d’Etudes Techniques et Economiques of Paris) has been engaged to assist the Corinto Port Authority in carrying out the study. The study will be closely coordinated with the Atlantic Port and Highway Survey being financed by the United Nations Development Program.

WORLD BANK LOANS DURING THE THIRD QUARTER OF FISCAL 1967

<table>
<thead>
<tr>
<th>Country</th>
<th>Purpose</th>
<th>Amount ($ millions)</th>
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</thead>
<tbody>
<tr>
<td>Cameroon</td>
<td>Agriculture</td>
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<tr>
<td>Congo (Brazzaville)</td>
<td>Industry</td>
<td>30.00</td>
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<tr>
<td>East Africa (Kenya, Tanzania, and Uganda)</td>
<td>Telecommunications</td>
<td>13.00</td>
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<td>Guatemala</td>
<td>Electric Power</td>
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<td>Jamaica</td>
<td>Telecommunications</td>
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<td>Pakistan</td>
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<tr>
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<tr>
<td>Trinidad and Tobago</td>
<td>Agriculture</td>
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<td>Tunisia</td>
<td>Agriculture</td>
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<td>Venezuela</td>
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<tr>
<td>Yugoslavia</td>
<td>Roads</td>
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Loans made during the third quarter of fiscal 1967: 144.70
Loans made during the first half of fiscal 1967: 626.40
Total amount lent during the first nine months of fiscal 1967 ended March 31, 1967: 771.10

IDA CREDITS DURING THE THIRD QUARTER OF FISCAL 1967

<table>
<thead>
<tr>
<th>Country</th>
<th>Purpose</th>
<th>Amount ($ millions)</th>
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<tr>
<td>Cameroon</td>
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<tr>
<td>Tunisia</td>
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Credits extended during the third quarter of fiscal 1967: 17.00
Credits extended during the first half of fiscal 1967: 304.59
Total for the nine months of fiscal 1967 ended March 31, 1967: 321.59

IFC INVESTMENTS ANNOUNCED DURING THE THIRD QUARTER OF FISCAL 1967

<table>
<thead>
<tr>
<th>Country</th>
<th>Type of Project</th>
<th>Amount in U.S. dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nigeria</td>
<td>Textiles</td>
<td>831,325.43</td>
</tr>
</tbody>
</table>

Investments announced during the first half of fiscal 1967: 34,543,923.00
Total investments announced during the nine months of fiscal 1967 ended March 31, 1967: 35,375,248.43
Recent Activity

INTERNATIONAL MONETARY FUND

1967 began with few Fund members near their drawing limits, although the total of drawings outstanding from the Fund was a record figure. During the first quarter of the year, 11 countries drew currencies equivalent to $285.5 million, raising total drawings on the Fund to an aggregate of more than $13 billion. By March 31, drawings outstanding from the IMF were $5.07 billion; repayments during the quarter totaled $64 million.

Drawings

A drawing in January by Spain was equivalent to $166 million in nine currencies; this corresponded approximately to the amount of Spain’s gold tranche position in the Fund. It was Spain’s first use of the Fund’s resources since 1959.

The Spanish drawing included Venezuelan bolívares, representing the initial use of this currency in Fund drawings. Drawings during the quarter also included for the first time Brazilian cruzeiros and Malayan dollars, when Colombia and Ceylon received these currencies in drawings made in March under the Fund’s compensatory financing facility (see below).

Stand-By Arrangements

During the first quarter of 1967 stand-by arrangements totaling $287.25 million were concluded with nine nations in Africa, Asia, Europe, and Latin America. The Fund’s assistance to these countries (Brazil, Burundi, Finland, Guyana, Korea, the Philippines, Somalia, Turkey, and Yugoslavia) illustrate some of the needs served by this facility.

The stand-by facility was established by a decision of the Fund’s Executive Directors in 1952. It is an arrangement that assures a member of its right to draw a stated amount of foreign exchange, under certain conditions, over a period as long as 12 months. In general, repayment terms (3 to 5 years), charges, and financial criteria are the same as for all drawings. But since a stand-by arrangement requires an assessment of the member’s financial prospects in later months, a statement of policy intentions is expected as a part of the arrangement.

The first arrangement in 1967 was in January for $45 million to assist Yugoslavia to liberalize its import and foreign exchange procedures. The Philippine arrangement for $55 million in January will help to maintain the country’s exchange and trade system free of restrictions and to promote its development in conditions of monetary stability. There followed a $5 million arrangement for Somalia, where foreign exchange income from banana exports is vulnerable to floods and droughts at home and to competitive markets abroad.

Guyana’s initial stand-by arrangement for $7.5 million in February, accompanies a program directed toward domestic and external
Recent Fund Activity

balance which is based partly on plans for new taxes. Guyana also established a par value for its currency in agreement with the Fund, and became the twenty-eighth member to undertake the obligations for currency convertibility contained in Article VIII of the Fund Agreement.

Turkey’s $27 million stand-by lends support to the country’s efforts to maintain a 7 per cent growth rate together with stable prices. The country’s reserve position is sometimes affected by failures in food crops, which lead to increased imports, and by reduced earnings from major export items such as cotton and tobacco.

Brazil’s new arrangement for $30 million parallels a continued effort to achieve financial stability, and succeeds an arrangement during which the member in fact reduced its Fund indebtedness. In the largest stand-by arrangement so far this year, Finland gained approval for drawings up to $93.75 million. It strengthens the country’s reserve position at a time of decline in exports of wood and paper products, and unusually large payments against imports.

Korea’s stand-by for $18 million will assist in strengthening the fluctuating unitary exchange rate system introduced in 1965 and will facilitate the elimination of restrictions on current payments. The new arrangement for $6 million for Burundi will help to meet temporary payments difficulties caused by a decline in world prices for Burundi coffee.

The Fund’s financial support in the form of a 12-month stand-by arrangement, or line of credit, has continued in active use over the past 15 years. Approximately one third of the total drawings on the Fund have been made in accord with 182 stand-by arrangements approved on behalf of 55 member nations, with some countries maintaining successive arrangements over periods of eight or nine years. The Fund has granted stand-by arrangements in order to sustain confidence in currencies, to provide additional resources during seasonal difficulties, to support programs intended to stabilize economies, to provide backing for monetary reforms, and for other purposes. They are sometimes requested as a precautionary measure with little expectation that drawings will be made, and have often expired unused. But they enable the authorities to administer import policies in the knowledge that a secondary line of reserves is available if needed. The Fund’s stand-by support may also facilitate the negotiation of other external credit for the country’s public and private sectors.

Undrawn balances available to members under their Fund stand-by arrangements reached a peak of $1.7 billion in 1963, when the United Kingdom alone was authorized to draw $1 billion. The U.K. arrangement was subsequently utilized in full. More recently the stand-by facility has been used in smaller total amounts, but always with at least 20 developing countries participating. The undrawn balances of stand-by arrangements in effect on March 31, 1967 were equivalent to $377 million.

Compensatory Financial Assistance

In March, Ceylon and Colombia drew $19.5 million and $18.9 million, respectively, under the Fund’s facility of compensatory financial assistance to members experiencing a temporary shortfall in total export earnings attributable to circumstances beyond their control. Declining world commodity prices during 1966
affected Colombia’s coffee export receipts and Ceylon’s earnings from exports of tea, rubber, and coconut products.

The facility of compensatory financing of export fluctuations which was liberalized in 1966 (see Finance and Development, Vol. III, No. 4, December 1966) is designed particularly to benefit primary producing countries. A member may obtain financial assistance from the Fund up to an amount equivalent to 50 per cent of its quota to compensate for temporary shortfalls in receipts from the medium-term trend value of exports, with the qualification that, except in the case of shortfalls resulting from disasters and major emergencies, outstanding drawings may not increase by more than 25 per cent of quota in any 12-month period.

Indonesia

Membership in the Fund increased to 106 nations when Indonesia rejoined the IMF in February with a quota of $207 million. Indonesia had joined the Fund in April 1954 and withdrew its membership in August 1965.

Total quotas in the Fund stood at $20.89 billion at the end of the quarter, reflecting Indonesia’s membership and quota increases for seven member nations (the Dominican Republic, Ivory Coast, Jordan, Lebanon, Malaysia, Turkey, and Viet-Nam) under the general increase in Fund quotas which went into effect in 1966.

Other Developments

In February, Guyana announced an initial par value for its currency at G$1 = US$0.58. Until 1965, the only currency in circulation in Guyana was the West Indian dollar issued by the British Caribbean Currency Board. The value of the Guyana dollar was fixed at parity with the West Indian dollar in November 1965 by the Bank of Guyana.

February saw the introduction of new currency units in Ghana and Brazil. In Ghana, where the new cedi is equivalent to 1.2 old cedis, the move did not involve any appreciation or depreciation of its currency. The Brazilian move introduced a new cruzeiro with a value of NCr$2.7 per U.S. dollar.
FUND STAND-BY ARRANGEMENTS
APPROVED DURING THE FIRST QUARTER OF 1967

<table>
<thead>
<tr>
<th>Member</th>
<th>Month</th>
<th>Amount ($ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>February</td>
<td>30.00</td>
</tr>
<tr>
<td>Burundi</td>
<td>March</td>
<td>6.00</td>
</tr>
<tr>
<td>Finland</td>
<td>March</td>
<td>93.75</td>
</tr>
<tr>
<td>Guatemala</td>
<td>March</td>
<td>13.40</td>
</tr>
<tr>
<td>Guyana</td>
<td>February</td>
<td>7.50</td>
</tr>
<tr>
<td>Korea</td>
<td>March</td>
<td>18.00</td>
</tr>
<tr>
<td>Philippines</td>
<td>January</td>
<td>55.00</td>
</tr>
<tr>
<td>Somalia</td>
<td>January</td>
<td>5.00</td>
</tr>
<tr>
<td>Turkey</td>
<td>February</td>
<td>27.00</td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>255.65</strong></td>
</tr>
</tbody>
</table>

DRAWINGS BY FUND MEMBERS
DURING THE FIRST QUARTER OF 1967

<table>
<thead>
<tr>
<th>Member</th>
<th>Month</th>
<th>Amount ($ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Afghanistan</td>
<td>March</td>
<td>2.00</td>
</tr>
<tr>
<td>Ceylon</td>
<td>March</td>
<td>25.75</td>
</tr>
<tr>
<td>Chile</td>
<td>January</td>
<td>10.00</td>
</tr>
<tr>
<td>Colombia</td>
<td>March</td>
<td>18.90</td>
</tr>
<tr>
<td>Finland</td>
<td>March</td>
<td>31.25</td>
</tr>
<tr>
<td>Iraq</td>
<td>February</td>
<td>20.00</td>
</tr>
<tr>
<td>Liberia</td>
<td>January, March</td>
<td>1.60</td>
</tr>
<tr>
<td>Sierra Leone</td>
<td>January</td>
<td>2.00</td>
</tr>
<tr>
<td>Spain</td>
<td>January</td>
<td>166.00</td>
</tr>
<tr>
<td>Sudan</td>
<td>February</td>
<td>5.00</td>
</tr>
<tr>
<td>Turkey</td>
<td>March</td>
<td>3.00</td>
</tr>
<tr>
<td><strong>Total drawings in the first quarter of 1967</strong></td>
<td><strong>285.50</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Total net drawings at the end of the first quarter of 1967</strong></td>
<td><strong>5,077.80</strong></td>
<td></td>
</tr>
</tbody>
</table>
FUND STAND-BY ARRANGEMENTS
as of March 31, 1967
in millions of U.S. dollars

- Afghanistan
- Bolivia
- Brazil
- Burundi
- Ceylon
- Ecuador
- Finland
- Ghana
- Guyana
- Haiti
- Korea
- Liberia
- Morocco
- Paraguay
- Philippines
- Rwanda
- Sierra Leone
- Somalia
- Sudan
- Tunisia
- Turkey
- Uruguay
- Yugoslavia

Amounts Agreed
Amounts Drawn
Central Banking Legislation
Volume II: Europe
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With the assistance of Jane B. Evensen

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From the reviews of Volume I

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