NEGOTIATING FUND PROGRAMS
ISSUES AND PROCEDURES

Also in this issue:
Financial appraisal of Bank World Bank and poverty Education and development Economic cooperation among LDCs Market factors in industrial projects Private sector and Korean growth Exchange rate policies in Asia

INTERVIEW:
Jacques de Larosière
Change of Editor

Samuel I. Katz
Editor of Finance & Development since 1977, completed his tenure in February 1982. Mr. Katz had succeeded Ian Bowen in February 1977.

Bahram Nowzad
is the new Editor. He was previously Assistant Director in the Exchange and Trade Relations Department of the Fund in charge of the External Finance Division.

Mr. Nowzad was educated in England at the Universities of Birmingham and Oxford. He has written widely on international economic subjects, including articles for Finance & Development.

NEW FROM THE WORLD BANK

International Comparisons Project: Phase III

World Product and Income:
International Comparisons of Real Gross Domestic Product
Irving B. Kraus, Alan Heston, and Robert Summers

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J. Price Gittinger

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The presentation is accessible to a broad readership of agricultural planners, engineers, and analysts. Differences between this and other methods of project analysis are delineated; financial economic concepts are explained for the nonspecialist; calculations are given in simple arithmetic; and the applications of a simple electronic calculator are detailed.

Approximately 432 pages. Cloth US$30.00 (£18.00), paper US$12.95 (£8.50).

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The Editor welcomes views and comments from readers on the contents of the magazine.
Graduation of borrowers from the World Bank is a firmly established principle and has been a long-standing practice. The graduation policy was reaffirmed at a meeting of the Bank's Board of Executive Directors recently.

Graduation is a process of slowly phasing out World Bank lending as the borrowing country reaches a level of development, management capacity, and access to capital markets that permits it to carry on without World Bank financing. The major features of this policy are the following:

1. Graduation is a logical step in the development process, and a clear set of guidelines for graduation from Bank lending is required.

2. Graduation should be a flexible and fair process, sensitive to each country's individual circumstances; special features, such as the problems of small countries with narrowly based economies, will be recognized in the phase-out program.

3. Graduation will normally occur within five years after a country reaches a per capita gross national product (GNP) benchmark, but this period might be longer if the situation deteriorates during the phase-out period.

4. Graduation should be seen as a stage in the evolving relationship between the borrowing country and the Bank; the Bank will continue to provide support to those countries that wish it after lending has ceased, including such services as technical assistance (assistance in project work and institution building, review of economic policies, and arrangements for private financing), continued access to the courses of the Bank's Economic Development Institute (which offers training to senior officials from developing countries), and continued eligibility for operations of the International Finance Corporation (IFC).

5. Once a program of graduation is agreed upon with the borrower, management will make a full report to Executive Directors.

6. The graduation issue, including any problem that may arise in the application of the per capita GNP level that triggers graduation, will be reviewed annually.

In 1973 the per capita GNP level that would trigger graduation was set at US$1,000 in 1970 prices. The 1980 equivalent is estimated at $2,650, after updating for inflation and exchange rate changes.

In its early years the Bank had made substantial loans to a number of industrial countries. By 1967, most of these borrowers had graduated. During the 1970s another group of higher income countries was graduated, including Finland, Greece, Iceland, Ireland, Israel, New Zealand, Singapore, Spain, and Venezuela.

The principle of graduation derives mainly from the Bank’s Articles of Agreement; these require that the Bank must, before making a loan, satisfy itself that the country cannot obtain the loan on reasonable terms in the private capital market. The Bank has interpreted this provision to refer to the extent of a country’s access to private markets for meeting its overall borrowing requirements at reasonable terms. But since “extent of access” and “reasonable terms” are not possible to measure precisely, the Bank has since 1973 used a per capita GNP benchmark as a proxy for the level of development that should normally warrant detailed consideration of graduation.

In practice, this guideline has been applied quite flexibly. By the time they actually graduated from Bank lending, nearly all of the countries mentioned above had per capita incomes substantially above that benchmark, even after adjusting for inflation. As overall constraints on the Bank’s resources including small countries with narrow economies, will be recognized in the phase-out program.

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have increased in recent years, there has been a need to review the Bank's graduation policies. This was done at the recent Board meeting.

**Graduation from IDA to IBRD**

The principal criteria for International Development Association (IDA) eligibility are also well established. These are lack of sufficient creditworthiness to meet capital requirements on commercial terms and per capita GNP below an established ceiling. The current per capita GNP ceiling for eligibility is $730 at 1980 prices, although in recent years the great bulk of IDA resources (nearly 90 per cent) has been allocated to countries with per capita incomes below $400.

A complete list of IDA graduates is shown in Table 2. Several of these countries, such as Jordan, Mauritius, and Paraguay, have been graduated because their income had exceeded the IDA eligibility level, while others such as Egypt, Indonesia, and Thailand were graduated because their creditworthiness reached a point where they could service loans on International Bank for Reconstruction and Development (IBRD) terms.

Countries will continue to graduate from IDA to IBRD lending. If the drastic reduction of resources continues (from the level of $4.1 billion originally planned for fiscal year 1982), the graduation process will have to be accelerated at a faster than desirable pace. Substitution of IBRD funds for IDA does not, however, offer a means of meeting the needs of most IDA countries, since few are sufficiently creditworthy to permit significant substitution and none could afford to borrow IBRD funds in amounts equal to current IDA lending.

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**Table 1**

**New commitments and use of Fund resources**

<table>
<thead>
<tr>
<th>Calendar year</th>
<th>January-March</th>
</tr>
</thead>
<tbody>
<tr>
<td>1a. New commitments (net of cancellations)</td>
<td>1.8</td>
</tr>
<tr>
<td>(Amount disbursed)</td>
<td>(1.4)</td>
</tr>
<tr>
<td>Industrial countries</td>
<td>—</td>
</tr>
<tr>
<td>Developing countries</td>
<td>1.8</td>
</tr>
<tr>
<td>1b. Purchases</td>
<td>0.7</td>
</tr>
<tr>
<td>Industrial countries</td>
<td>—</td>
</tr>
<tr>
<td>Developing countries</td>
<td>0.7</td>
</tr>
<tr>
<td>2. Trust Fund loans disbursed</td>
<td>0.5</td>
</tr>
<tr>
<td>Developing countries only</td>
<td>—</td>
</tr>
<tr>
<td>Total (1 + 2)</td>
<td>3.0</td>
</tr>
</tbody>
</table>

**Table 2**

**Summary of transactions, 1978-82**

<table>
<thead>
<tr>
<th>Calendar year</th>
<th>January-March</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reserve tranche</td>
<td>3,744.3</td>
</tr>
<tr>
<td>Credit tranche</td>
<td>2,535.5</td>
</tr>
<tr>
<td>(Of which, supplementary financing facility)</td>
<td>421.0</td>
</tr>
<tr>
<td>(Of which, enlarged access)</td>
<td>—</td>
</tr>
<tr>
<td>Compensatory financing</td>
<td>577.7</td>
</tr>
<tr>
<td>Extended facility</td>
<td>174.0</td>
</tr>
<tr>
<td>(Of which, supplementary financing facility)</td>
<td>—</td>
</tr>
<tr>
<td>(Of which, enlarged access)</td>
<td>—</td>
</tr>
<tr>
<td>Buffer stock</td>
<td>36.1</td>
</tr>
<tr>
<td>Total repurchases</td>
<td>4,845.2</td>
</tr>
<tr>
<td>Trust Fund loans</td>
<td>688.1</td>
</tr>
</tbody>
</table>

---

**New members**

On February 25 Antigua and Barbuda became a member of the Fund with a quota of SDR 3.6 million and Belize joined on March 16 with a quota of SDR 7.2 million.

With the admission of the Hungarian People's Republic on May 6, the Fund now comprises 146 member countries. The Hungarian quota, SDR 375 million, brings total members' quotas to SDR 61,059,800,000.
A conversation with Mr. de Larosière

The Managing Director of the Fund interviewed by Finance & Development

Q. In recent speeches you have emphasized that industrial countries must persevere with their strict financial policies to bring down inflation. In the light of unemployment and reduced economic activity—both particularly harmful to the developing countries as well—isn't the cost too high? Why doesn't the Fund promote other policies, for example, complementary incomes policies to reduce inflationary expectations?

A. I think that what we have to stress now is that unemployment and reduced economic activity have been bred by years of inflation and lax financial policies. There is no way of reducing unemployment by rekindling inflation. Countries have tried that in the past and it just doesn't work. Some immediate but artificial activity could well be created by a relaxation of demand management but sooner or later, probably sooner rather than later, inflation would get worse, savings would abate again, and balance of payments problems would become more acute; countries following those policies would be compelled to return to more restrictive financial policies which would, at that time, be even more costly for them and for the world as a whole. For this reason, we in the Fund strongly encourage all countries to engage in strong anti-inflationary struggles and to carry out these policies to the end.

On the costs to developing countries, I would like to point out that the Fund staff has been working on various scenarios for the World Economic Outlook. One scenario, which we call the central scenario, assumes that the industrial countries are successful in their anti-inflationary policies and by 1984 manage to return to sounder growth. In the second scenario, the same countries are assumed to relax their demand policies now. Clearly this second scenario would have much more serious, in fact dramatic, consequences on the developing countries than the first one in terms of growth and international trade. But the developing countries are not only interested in seeing that the industrial countries remain resolute in their efforts to control inflation, they are also keenly interested in the modalities of this anti-inflationary policy. They are particularly interested in the mix of fiscal and monetary policies adopted by major industrial countries and, of course, interested in its implications for interest rates in the world. They are also keenly interested in the approaches of industrial countries toward the question of open trade and official development assistance.

Q. Many observers purport to have detected a sharp change in the degree of Fund conditionality in recent years. Specifically, they claim that there was a substantial loosening until about a year ago, but that the pendulum has swung since then toward much tighter conditionality. First, is this true? If so, what are the reasons for it?

A. To answer that question one has to recall what conditionality is about. Conditionality refers to the economic and financial measures which are needed in a particular country in order to restore a sustainable external position at the end or toward the end of a Fund program—that is, a deficit that can be financed by long-term capital flows without undue burden or strain on the debt service position of the country in question. For instance, if a country runs a balance of payments current deficit amounting to let's say 8 per cent of its gross domestic product (GDP), and if in that particular case its sustainable deficit is considered to be in the order of 2 per cent of its GDP, an adequate three-year adjustment program would imply an adjustment of some 2 percentage points a year in the deficit of that country. But, suppose now, for the sake of the argument, that this same country has moved into a worse balance of payments position. For instance, a deficit of 12 per cent instead of 8 per cent of GDP because of an irreversible...
deterioration in its terms of trade or and because of a slippage in its domestic financial policies. Its long-term sustainable financiable position has not by the same token changed and it is still, in my example, at 2 per cent of GDP. The necessary adjustment would imply a reduction of a little more than 3 percentage points a year in the course of the three-year program. Now, in such a situation, which in fact often happens and has occurred in 1980 and 1981 with the worsening of international recession, the perception might have arisen that conditionality has tightened. But what has really happened is not a tightening of conditionality per se, it is a worsening of the external conditions of the country in question and the need for more adjustments.

A number of programs designed in 1979–80 have encountered such problems; putting these programs back on track implies in most cases supplementary adjustment measures. It has become necessary for the Fund, in view of these changing conditions, to obtain from members requesting assistance substantial assurances that the requisite adjustment measures would, in effect, be undertaken. More and more often the assurances are best provided by members willing and able to undertake policy measures right at the beginning of their programs and this is a requirement that the Fund relies upon quite frequently now. It is important to have a clear understanding and a consensus on the crucial importance of conditionality in the present conditions. In the wake of the first oil shock, such a consensus had not been reached. Unconditional facilities, or facilities with light conditionality, were resorted to or designed in the expectation that the balance of payments problems might be reversible. It became very clear by 1978 that such an unconditional or "recycling-oriented" approach was not warranted by the realities of the situation as we saw it evolve at that time. Balance of payments must be adjusted and the Fund must link its high credit tranche resources to the adoption of meaningful adjustment policies by member countries.

Why did some people perceive or feel a loosening of conditionality a few years ago? Perhaps because conditionality was being again applied after a period of practically no conditional lending in favor of developing countries from 1974 to 1978. In addition, in the wake of the second oil shock and the consecutive explosion of external imbalances in 1979–80 the amounts of financial support provided by the Fund had rightly been increased in order to give the Fund that "critical mass" which is needed to entice member countries to agree on meaningful and realistic programs, and also to catalyze the provision of other external funds needed for the financing of the balance of payments problems in question.

In reality the degree of adjustment measured in terms of, for instance, annual reductions in external deficits relative to GDP has not decreased since 1978 as measured against the Fund's long-lasting standards or experience. It has, if anything, increased because of the increase in the magnitude of the problems.

To summarize my answer I would say three things: 1) the Fund decided to abandon pure recycling methods after 1978; 2) the Fund decided to equip itself better financially in order to cope with balance of payments problems as they emerged in the wake of the second oil crisis in 1979–80; and 3) with the worsening of world conditions in the recent period the Fund has often insisted on supplementary measures to be taken by member countries in order to restore the initial objectives of Fund programs which had gone off track. Thus, as has been the case for more than 30 years, Fund conditionality has been constantly adapted—in the framework of its guidelines and under the guidance and control of its Executive Board—to the size of the imbalances and the stronger adjustment efforts they called for.

It is, of course, quite obvious that one cannot always resolve everything in one, two, or three years, especially in the case of the poorest countries whose abilities to effect adjustments are quite limited. In such cases, however, I do not believe the solution is to be found solely with the IMF. The Fund is not a development assistance agency. It has extended its terms and may now lend for up to 10 years within the framework of extended arrangements. But the structural difficulties that the least developed countries face in a complicated world cannot be resolved by an uncontrolled expansion of the lending facilities of the Fund. This approach would be fruitless and contrary to the very purpose of our institution, which is to provide medium-term balance of payments assistance on a revolving basis. If we think a country is not in a position to right its balance of payments within a few years, and that the adjustment measures that ought to be taken go beyond socially tolerable limits in the country concerned, the proper solution is to present the problem to the international community in very clear terms. We have done this on several occasions in the recent past. In cooperation with the World Bank, we then ask potential creditor countries directly concerned with the economic future of the country in question to take a close look at the financing problems. In the event, restoring a viable balance of payments position in such a country requires more than an improvement in economic policies; it entails long-term or grant-type international assistance as well. The Fund can play a useful role in implementing a "concerted action" which includes both a recovery program supported by the Fund and balance of payments assistance or development assistance from various other sources.

Q. When it comes to affecting policies of individual countries, some observers claim the Fund’s influence is severely limited, and only to deficit countries that come to the Fund for financing rather than to the market. Is this fair?

A. It is a fact that some countries need Fund financial support and, in order to obtain it, have to engage in negotiations on economic and financial measures incorporated in the programs, while some other countries do not have to resort to the Fund’s financial support either because they have ample access to capital markets or because they are in a surplus position. Now we can’t change that basic situation. But I think it would be wrong to infer from it that the Fund has little or no influence on its other member countries. As you know, the Fund has a surveillance function whereby it conducts with each of its member countries
consultations on the policies of those countries, and this surveillance function is a very important one. We must strive in the Fund, and we do strive, to act in such a way that the Fund exercises surveillance over the exchange and related policies of all its members, those with a high degree of financial autonomy and those which have to borrow from the Fund, in a spirit of symmetry.

I referred a moment ago to the mix of monetary and budgetary policies in major industrial countries which is so relevant for the world as a whole and for interest rates on the international markets which have such a bearing on developing countries. The International Monetary Fund has laid considerable stress on this matter in its consultations with the industrial countries, in its World Economic Outlook documents, and in my public statements. There are perhaps no immediate operational sanctions attached to our recommendations on surveillance but the Fund is an institution which holds a very high moral authority. A country, or a group of countries, which were openly in violation of the Fund’s major surveillance recommendations would be put under very strong pressure to right its or their situation. The existence of this surveillance function perhaps explains why there has been, in a time of floating rates, no open recourse to manipulation of exchange rates for competitive objectives.

Q. The Fund is now involved in a large number of low-income African countries. Many believe that in these countries, the problems of the balance of payments are inseparable from the problems of development and that, consequently, a true adjustment program would be a development program. Do you agree with this view? Is it not the case that these countries require far more economic aid than balance of payments assistance on Fund terms?

A. It is indeed true that the problems of many poor African countries are large and of difficult solution. Dealing with them on a systematic basis requires a careful analysis of the causes and nature of the balance of payments problems. It is important to ascertain whether they are temporary or permanent in character, and whether they are of internal or external origin. Such an analysis is an obvious first step before a balance of payments adjustment program can be designed for any one country. It is, of course, true that external circumstances, especially changes in terms of trade, do affect heavily the balance of payments position of African countries. It is fully within the competence of the Fund to assist countries to adjust to such developments. Externally originated imbalances, when they are permanent, need to be adjusted.

It is also true that in many instances the persistent balance of payments problems of most African countries have originated or have been compounded by inappropriate domestic adjustment responses to the impact of adverse external factors; we have had many cases where the implementation of domestic policies to keep domestic demand beyond sustainable levels has provoked external imbalances and at the same time has discouraged domestic supply through inefficient resource allocation and use. I hasten to say that these developments are not limited to Africa. Many other regions in the world, developed or developing, are the scene of similar inappropriate policy responses.

Adjustment programs supported by the Fund are directed at correcting the effects of inappropriate policies and of lasting deterioration in terms of trade and to this end they include demand restraint as well as supply-oriented measures. It is well known, of course, that the Fund’s balance of payments assistance is temporary and revolving in character and limited to a specific multiple of the member’s quota. These limitations and characteristics of the Fund’s intervention are an essential feature of the Fund and will not be changed. But it is important when devising a balance of payments adjustment program for a Fund staff mission not to make the wrong choices or the wrong recommendations as far as actual conditions are concerned. A fiscal or a pricing policy obviously has a major impact on the allocation of resources and the fundamental economic structural components of an economy. A monetary policy can discourage savings and encourage imports, or promote exports and encourage savings. So what is important is not that the Fund gets into long-term structural policies, but that the Fund, in designing a medium-term balance of payments stabilization program, should make sure that its adjustment measures are not incompatible with the long-term structural changes which are necessary in a country. That is why it is so important that Fund balance of payments missions rely in this area on the expertise of the World Bank. We have to cooperate actively with the World Bank in reaching the appropriate choices on stabilization measures which can have an impact, and a lasting impact, on the structural future of the country.

Q. Do you think that it is possible—or even sensible—to try to keep the Fund and Bank completely separate? Or would it be better to recognize that there is a degree of overlap and to try to promote coordinated and parallel activities?

A. The difference between the Fund and a development lending institution, such as the World Bank, can be seen most clearly by looking at the nature of the Fund’s lending and the policy focus of its programs.

The Fund’s resources are of a revolving nature. I spoke of this earlier. Countries borrow from the Fund when faced with temporary balance of payments disequilibria. The Fund provides this financing in the context of a policy program which is designed to return the country to a balance of payments position which can be sustained without continued recourse to exceptional financing and which enables the country to repay the Fund within a few years. The time frame of a Fund program, the policies adopted, and the financing provided all depend upon the nature and size of the disequilibrium, but the central feature of the program is always the implementation of a consistent set of macroeconomic policies which will enable the country to reestablish a sustainable balance between aggregate demand and supply in the economy.

The main objective of development lending, on the other hand, is to enable a country to invest more than it is able to save, thereby increasing its stock of capital faster than would otherwise be possible and raising its rate of growth over the long term. The basic assumption is that the country will, on average, have a current account deficit which is financed, inter alia, by development lending and that this net resource transfer will continue.
until some time in the future when the country reaches a higher stage of development. The primary policy focus of a development institution is, therefore, on the efficient use of productive resources. Is investment being directed toward the sectors and projects with the highest economic return? Does the incentive structure ensure that scarce resources are allocated efficiently?

Having drawn this essential distinction between the basic natures of the two types of institutions, I must emphasize that there are important areas of interdependence between the objectives sought by each. While the Fund and the Bank retain their separate responsibilities and functions, we call upon each other for advice within each institution's area of expertise and consult and collaborate so as to ensure that the efforts of each institution reinforce the effectiveness of the programs supported by the other. The Fund, for example, looks to the Bank for views on the size and composition of a country's investment program and for analysis of the microeconomic impact of pricing decisions, while the Fund provides the Bank with guidance on macroeconomic policies. Both institutions have found this type of collaboration to be most fruitful, and we fully intend to continue and expand our efforts in this direction in the future. It is, for example, becoming more common for staff members from one organization to participate in missions of the other.

Q. We read increasingly that Fund financial programs with members have broken down because the country was unable to meet performance criteria. Does this trend disturb you? What are the causes? Were the programs unrealistic to start with, or was the breakdown due to circumstances beyond the control of a particular country?

A. Well, first of all, I would like to answer by facts. Last September the Executive Board of the Fund reviewed the performance of all 23 member countries for which upper credit tranche stand-by arrangements were approved in 1978–79. This review showed that performance toward the major targets under these programs was as follows. First, the targets for the current account of the balance of payments were fully achieved in half of the programs. The current account improved in relation to GDP in almost two thirds of the cases. Second, the original targets for inflation were also achieved in about one half of the programs. Although the rate of price increase actually declined in only about a third of the programs, many of the programs provided for wide-ranging increases in officially set prices for price decontrol. Third, in almost two thirds of the programs credit expansion slowed down. On average for all programs the rate of credit expansion declined by more than 20 per cent. Fourth, on the fiscal front, substantial budgetary adjustments were made by many members. In more than a third of the programs the budget adjustment exceeded 2 per cent of GNP. In about a fifth of the programs the improvement in the budget was as high as 5 per cent of GNP or even more.

Now this performance is very obviously a mixed one and actual performance fell short of the targets in a number of cases. I would say roughly half. But here I would like to make a few remarks. First of all this is hardly surprising when one allows for the fact that conditions in the world economy during this period turned out to be much worse than expected when many of the programs were drawn up. In particular, the second wave of oil price increases took place during the period, adding to the strains on the balance of payments of many of these countries. Second, the record shows that the Fund’s programs have been healthy, albeit with the shortcomings that our review pinpointed, and they have been helping the borrowing countries to adjust and the world at large to achieve better international payments conditions. But there is much scope for achieving further improvement in the implementation of programs and this was recognized amply by the Executive Board during the last review. It was felt that much could be gained by putting more emphasis on early and prior policy action by member countries seeking Fund support. Improvements in our monitoring methods and devices were also called for. More extensive use of technical assistance by the Fund, particularly in the fiscal field, in helping countries to devise and carry out programs was also suggested.

To summarize, my answer to your question is yes, I am disturbed by the mixed performance of a number of our programs. Incomplete programs always should concern the Fund. Whenever such instances arise, we analyse these cases in detail to get at their causes, to find out whether they are the result of faulty programming, faulty implementation, or unanticipated events. Let me stress here that there are hardly ever any instances where causes of departures from the agreed programs can be classified in a very neat fashion. But to the extent feasible we try, and we must try, to ascertain their relative importance, and we are continually trying to find practical ways of eliminating or at least minimizing them.

The importance of performance criteria as signposts cannot be overstressed in a world economic environment that has not contributed to easing the problems of adjustment of members.

You mentioned in your question circumstances beyond the control of the member as one of the possible reasons for departure. There are, of course, numerous examples of this particular kind, most notably in recent times, energy price developments and, as I said a moment ago, recession and interest rate hikes. In many respects, they are the relatively simplest factors to identify, if not to deal with. If the circumstances are transitory, the departure is also bound to be transitory, and the program can be expected, without major changes, to return on track in due course. But, if these circumstances are not reversible, then further measures must be taken and there are well-established methods to reach understandings on the required policy adaptations.

In this context, I would recall that consultation clauses between the members and the Fund are standard features of Fund arrangements. More important, we should not lose sight of one of the most, if not the most, important roles of performance criteria. They are devised to provide signals about the performance of the economy. Thus, lack of observance, while it cannot be overstressed in the world economic environment that has not contributed to easing the problems of adjustment of members. Such an environment not only increases the hazards associated with the design of performance criteria but makes it difficult for many countries to steer a steady policy course for a sustained period.

continued on page 45
A financial appraisal of the Bank

Speaking before representatives of the financial community in New York on February 25, 1982, the President of the World Bank, A. W. Clausen, discussed the financial policies and operations of the World Bank. The following text is excerpted from his talk.

... The function of the World Bank, quite simply, is to provide financial and technical assistance to stimulate growth and productivity in our developing member countries.

In fulfilling that function, the Bank performs a unique and critically important international role—a role of financial intermediary that serves the interests of the industrial as well as the developing countries. We are carrying out that role at a time of growing difficulty and complexity in the global economy. After 31 years as a commercial banker, I accepted the presidency of the World Bank because I believe that the development of the emerging world and the attendant improvement in the standard of living of those people is one of the most challenging tasks confronting us in the final decades of the twentieth century. I believe the World Bank’s role in helping to meet this challenge is more important than ever. . . .

To begin with, the Bank is, as the name implies, a bank. It’s a very sound and prudent bank. But it is more than, and different from, the kind of bank we are usually accustomed to. It is an international development institution, with most of the world’s governments as its shareholders—the United States being the largest.

Even though the Bank is wholly owned by governments, its philosophy is grounded in the interdependence of the public and private sectors. This concept is reflected fully in our founding charter and remains the touchstone of our operations. Indeed, the private sector—in terms of the investor community throughout the world—is the primary source of the World Bank’s lending to developing countries. We borrow from the private capital markets all over the world and lend to the developing countries on the basis of sound economic criteria for productive purposes that enhance the prospects for further private investment and effort—both local and international.

It will not surprise you that having been a commercial banker for so many years, one of the first things I did was to look carefully at the way the World Bank operates on traditional financial terms. At the outset, let me say, I have been impressed with the record established: a loan portfolio that has not suffered one penny of loss in the Bank’s entire 35 years of operations; a firm policy against any participation in debt reschedulings; callable capital of US$35 billion from the world’s governments—to be increased to $72 billion—that serves exclusively as a guarantee for the protection of the Bank’s bondholders; high-quality liquid assets amounting to more than $8 billion; and annual net profits—currently running at the level of about $600 million a year—realized every year since 1948, of which more than $3 billion have been plowed back into the institution to strengthen its equity base. The fact is, it is an overwhelmingly strong institution as measured in purely traditional financial terms.

Financial assets

The Bank essentially has two financial assets: its outstanding loans and its liquidity. On the liability side, it has outstanding debt and a unique capital structure. I want to touch on each of these items briefly in an effort to explain how the Bank functions as a unique profitable and sound financial institution.

Since it began operations in 1946, the Bank has loaned about $71 billion. Of this amount, approximately $13 billion has already been repaid or sold to other parties, leaving about $58 billion of committed loans. However, $29 billion of this balance still remains undisbursed—to be drawn down by borrowers over the next six to seven years. Therefore, the World Bank’s accounts receivable, currently disbursed, and outstanding, is about $29 billion. It is expected to rise to about $32 billion by June 30, 1982. That represents the Bank’s risk assets. It is our loan portfolio. What has been the financial experience with that portfolio?

In the first place, the Bank has never had a default on any of its loans.... It has never had a nonaccruing loan.... It has never suffered a loss on a loan.... We have seen numerous changes of governments in countries but without exception the successor governments have honored their predecessors’ obligations to the Bank.

The Bank has a firm policy against debt rescheduling and does not participate in such exercises. It does not change the interest, the principal, or the terms of a loan after it has been approved. Nor does the Bank refinance loans to permit its borrowers to service their debt. It is a project lender for the most part and does not provide a cash flow to its borrowers. In exceptional circumstances, nonproject lending may be considered but the conditionality is stringent and, furthermore, this type of lending in any one year has never exceeded 10 per cent of total annual commitments.

It takes, on average, more than two years to help a country develop and then to appraise a project before it is presented to the Bank’s Board of Directors for loan approval. The Bank’s investigation covers all aspects of the project: economic, technical, financial, organizational, managerial, and operational. The project must be of high priority to the economic growth of the country. If it is not, the Bank will not finance it. . . .

Of $4 billion in interest and principal and other charges due to the Bank from its loans for the fiscal year which ended on June 30, 1981, only approximately $160,000 of interest was more than 60 days past due on that date and only $1.6 million in principal was similarly late. By October 22, the date of our first prospectus in the United States after June 30, 1981, all of even these trivial amounts had been paid.

The second major asset of the World Bank is its liquidity. The Bank’s liquid cash balances are currently about $8 billion and at the end of this fiscal year, June 30, 1982, will stand at about $10 billion. That liquid- ity is equal to about one third of all our outstanding debt.

Why do we keep such a high level of liquidity? First, it has been a consistent
profit center of the Bank invested at higher returns than the cost of borrowing. Second, it gives us flexibility on when, where, and how much to borrow. We simply draw it down when rates are high or capital markets are unstable and build it up (by borrowing more than we have to) when we have access to stable capital markets at low costs. Quite simply, we do not wish to be captive to unstable markets. Therefore, we hold liquidity.

One final point on our liquidity. We never take a currency risk on our liquidity. We do not speculate among the different currencies. Our job, however, is to predict interest rates in the 20 different currencies which make up our liquidity—to decide whether to be long or short—and to manage the liquidity so it produces the highest financial rate of return. That, in turn, permits us to keep our lending rate at a minimum without jeopardizing the Bank’s profitability.

Liabilities

Let me turn now to some specifics about the liability side of the balance sheet. We expect our outstanding debt to be about $34 billion at June 30, 1982. The main characteristics of that indebtedness are quite different from those of a commercial bank.

First, it is in 16 different currencies and the Bank does not take a currency risk on its borrowings.

Second, the average life of the Bank’s debt is seven years; all at fixed interest rates. For the World Bank to obtain funds for its lending, it must meet the rather vigorous tests of the medium- and long-term capital markets—the demands of the insurance companies, pension funds, and other institutional investors. Because of the success of our borrowing program, we have not found it necessary to have a “discount note” or CD [certificate of deposit] base of funds or to issue other forms of variable rate paper.

About 30 per cent of our debt is held by central banks or governments who have bought our paper, mostly through direct private placements, and who hold our obligations as part of their foreign exchange reserves.

The balance of our debt comes from private financial marketplaces all over the world. We are the largest nonresident borrower in the world in every capital-exporting country.

- We are a triple-A borrower everywhere.
- The maturities of our debt range from 2 years to 25 years.
- We estimate that only $6–7 billion of our debt is held by U.S. investors. As much paper has been placed by the Swiss, the Germans, and the Japanese, each, as by the U.S. investment banking community. This is not to say that the United States market does not figure prominently in our plans. It does indeed. We have just recently returned to the American market after an absence of several years, but it is our intention to be a regular participant in this market from here on out.

- OPEC [Organization of Petroleum Exporting Countries] has supplied 15-20 per cent of our outstanding debt—mostly by means of 5-12 year fixed rate direct private placements in half a dozen currencies.

We have adopted a policy of diversifying our indebtedness by currency, by country, by source, by maturity, by technique of borrowing. We do 50-60 different public issues, private placements, and fixed rate syndicated loans a year. We never rely on one method, source, or market. We will not be hostage to one environment...

In 1975, the cost of our then $12 billion of outstanding debt was 7.2 per cent. We project that as of June 30, 1982, after years of inflation and the erosion of the fixed rate markets, we will have outstanding debt of $33 billion—almost a 300 per cent increase. We project the cost will be about 8.2 per cent!

In one sense, we are very much like a commercial bank, but instead of matching short-term and volatile funding with similarly variable rate loans, we seek to make medium- and long-term fixed rate loans and fund them with medium- and long-term fixed rate borrowings. When the time comes that fixed rate resources are insufficient to meet the size of our lending program, we will simply consider variable rate borrowing and, of course, variable rate lending in some form or another.

Capital structure

Permit me now to say a word or two about the unique features of the Bank’s capital structure.

The Bank’s equity as of June 30, 1982, is projected to be about $9 billion. That equity is divided into two roughly equal parts: retained earnings and paid-in capital. We have never paid dividends on equity, not because we could not but because we chose not to do so.

As you can see, we have a debt/equity ratio of about 4 to 1, as compared to a commercial bank’s 25 to 1. Not bad—particularly for an institution which has never suffered a loss on a loan and does not participate in rescheduling or refinancings and has almost $10 billion in cash.

As I mentioned earlier, the outstanding projected debt of $33 billion is expected to cost about 8.2 per cent as of June 30, 1982. Thus, the cost of total funds (debt plus equity) will be about 6.5 per cent as of June 30, 1982. Our current lending rate is 11.6 per cent.

Another unique feature about the Bank is its subscribed capital. The $4 billion of paid-in capital represents only 10 per cent of the Bank’s total subscribed capital. It is the portion that is actually paid to the World Bank by its member governments and is available for use in our general lending operations. But it is just the tip of the iceberg. There is, in addition, another $36 billion of callable capital. There are several points to consider with respect to the Bank’s callable capital.

First, it can never be used to run the Bank. It can never be used for disbursements to developing countries. It is solely for the protection of the Bank’s bondholders or other creditors. The only time it can be used is to meet obligations to bondholders or creditors if we need to call on it. We never have had to call on it, and we never expect to. Not with the quality of our loan portfolio, our cash position, profits, sources of funds, and our loan experience.

Nonetheless, the larger the amount of callable capital, the greater the protection for the bondholder. It is the icing on a very palatable “financial cake.”

The Bank operates, however, as if that “guarantee” fund does not exist. It operates with prudent and meticulous financial policies. The Bank’s shareholders insist on it. They guide the Bank’s financial policies with a full understanding that their callable capital is at risk in that it is a guarantee to bondholders.

We are now in the process of receiving over the next four to five years another $40 billion in capital which member countries have agreed to subscribe. Three billion dollars will be paid in and $27 billion will be added to our callable capital. Pro forma, that will give us about $72 billion of callable capital—guarantee capital if you will—in the mid- to late 1980s, plus over $7 billion of paid-in capital, plus about the same amount—$7 or $8 billion—of retained earnings. That tallies up to an aggregate equity base of more than $85 billion.

Bank profits have risen dramatically. From $170 million in the early 1970s to $400 million in the late 1970s and then to $600 million in 1981, in part because of our equity base compared to debt, in part because of the composition of that debt, and in part because of returns on liquidity. We are rather satisfied with that picture considering we lend long term at fixed interest rates. Our forecasts indicate that profits will remain at or about current levels for the next few years. We intend to remain a profit-making institution.

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What are the major questions that emerge in negotiations for the use of Fund resources between member governments and Fund staff? What is the process by which such negotiations are conducted? An overview of issues and procedures.

Andrew Crockett

Over the last three years, in the face of unprecedentedly large global payments disequilibria, the Fund has been more active than ever before in making its resources available to members in support of programs of balance of payments (BOP) adjustment. From January 1979 until December 1981, 88 arrangements were approved for a total of SDR 24.4 billion, compared with 54 arrangements totaling SDR 8.1 billion in the previous three years. Of the 1979–81 total, 73 arrangements in the sum of SDR 23.7 billion were either upper credit tranche stand-bys or extended arrangements; this compared with 29 arrangements for SDR 7.5 billion in the earlier three years.

The use of Fund resources under these facilities is usually preceded by intensive discussions between the authorities of member countries and the Fund's management and staff concerning the economic policies to be adopted to correct the payments disequilibrium that gave rise to the financing need. This article describes a number of representative issues that arise in such discussions.

In analysing these issues, it must be borne in mind that the Fund's essential purpose is the promotion of effective BOP adjustment. Both under the terms of its charter and because of the limited and revolving nature of the resources at its disposal, it must be assured that Fund lending supports policies that offer a firm prospect of achieving a sustainable payments position. In itself, this approach is not a source of controversy, since all member countries accept that the eventual restoration of external equilibrium is a constraint on policy that would apply regardless of the nature of the international economic system. It is therefore over the means by which such an equilibrium is achieved and maintained that differences of opinion chiefly arise.

Such differences reflect not only disagreements about the impact of particular economic measures on the BOP but also divergent perceptions of the way in which these measures impinge on the domestic policy objectives of the country concerned. As far as the latter are concerned, the Fund endeavors to ensure that programs supported by its resources achieve the desired degree of adjustment without causing undue harm to domestic goals, such as the growth of output and investment, and the equitable distribution of income.

Adjustment need

A first step in the formulation of a program to be supported by the Fund's resources is to assess the extent of the BOP improvement required and the member's need for additional foreign exchange resources while that improvement is taking place. As just mentioned, the Fund can lend only for programs that give promise that the economy will be restored to a viable payments position. Such a position can be defined as one in which any remaining deficit on current account can be covered by sustainable capital flows—sustainable in the sense that they represent a willing long-term transfer of resources from overseas creditors and are consistent with the debt-servicing capacity of the economy.

For countries with limited access to international capital markets, an estimate of sustainable capital inflows is usually arrived at by assessing the economic assistance that is likely to be available from bilateral and multilateral sources during and after the period of adjustment. Where
in the use of Fund resources

countries are in a position to tap additional, private, sources of foreign financing, an estimate is needed of the country's capacity to attract and service additional debt. This assessment depends on a number of factors that cannot be forecast with any precision, such as the level of real activity in the world economy, international interest rates, the availability of finance for international lending, and the success of individual borrowing countries in achieving their objectives for growth in output, investment, and exports.

Not surprisingly, differences of view arise between the Fund staff and member authorities concerning what constitutes a viable payments position on current account and how rapidly it is feasible to attain it. Sometimes, the authorities in developing countries will argue that it is unfair to expect them to compress their current BOP deficit (which represents the net flow of real resources from the rest of the world), when their payment difficulties have arisen from factors largely beyond their control. They would prefer to plan an adjustment strategy on the assumption that the world economic climate will improve, perhaps with an implicit hope that additional resources would be available through the Fund to finance them in the event that it did not.

As noted above, however, the resources the Fund can make available to members in deficit are strictly limited. Under existing credit tranche policies the maximum that a member can borrow is one and a half times its quota subscription in any year, or four and a half times its quota over three years. (On average, Fund quotas are currently about 3 per cent of annual imports, though variations around this average are quite substantial.) If such lending is to be repaid, and if borrowing members are not to run into insurmountable difficulties when access to the Fund's resources has been exhausted, lending must be accompanied by a planned program of economic rehabilitation. This need applies regardless of whether the factors that have given rise to an underlying payments disequilibrium are of internal or external origin.

Adjustment policies

At some risk of oversimplification, the kinds of measures and policies that usually form part of programs supported by use of the Fund's resources can be grouped into three broad (and not always distinct) categories:

- the management of the level and structure of aggregate demand;
- the enhancement of the economy's supply capacity, particularly of tradable goods; and
- measures to shift the structure of output toward net exports.

Ensuring that aggregate demand is consistent with the economy's supply capacity

Procedures in establishing adjustment programs

Initiation. There is no fixed procedure for initiating discussions on a program to be supported by the Fund's resources. The Fund has regular contact with member authorities through annual Article IV consultations (on exchange rate arrangements), through the Executive Directors, and through other visits either by Fund staff to member countries or by member government officials to Washington, D.C. Whenever BOP trends suggest that a financing gap is or may be emerging, the nature and scope of possible adjustment measures is a central feature of discussions during these contacts. At such times, the member country may request Fund assistance in designing a suitable program, or the Fund staff may itself suggest the advantages of comprehensive adjustment measures supported by use of the Fund's resources. If, as occurs in quite a significant number of cases, a country is already using resources in the first credit tranche, a dialogue would already have begun, albeit on a less comprehensive basis than would be needed for a program supported by resource use in the upper credit tranches.

Request for assistance. The actual request to initiate discussions on the use of Fund resources, whether in the upper credit tranches or under the Fund's other facilities, need not be formal. Typically, the authorities of a member country will indicate to the Fund staff or to their Executive Director their wish to discuss a possible arrangement, and this will be immediately communicated to the Managing Director. The request and the subsequent discussions are confidential and, as far as possible, unpublicized. This is because the policies that will be under discussion are sensitive and the success of the discussions cannot be assured; in the event that agreement cannot be reached, it is often desirable to avoid unnecessary speculation on the reasons for the disagreement.

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and the authorities' objectives for price stability and the BOP is always a central aspect of macroeconomic policy. Beyond this, supply-side measures have received increasing emphasis in recent years, with the assistance of the World Bank, because of a growing realization that exploiting the scope that often exists for improvements in resource allocation can reduce the burden of external adjustment and increase economic welfare. Last, shifting the pattern of output toward exports and import substitution, often involving action on the exchange rate, is frequently necessary to provide a more immediate and direct incentive to shift resources toward an improvement in the BOP.

**Demand management.** In formulating a program with the Fund, member countries usually establish objectives for the rate of growth of output and investment and the moderation of inflation, as well as for the BOP. These objectives affect the flows of real and financial resources among sectors of the economy and between domestic and foreign sectors. They also usually require policy measures to ensure that the level and distribution of demand are consistent with the authorities' broad macroeconomic objectives.

Much empirical evidence confirms that the rates of growth of monetary and credit aggregates affect the rate of nominal income growth and the BOP. Inevitably, therefore, understandings on monetary policy are an important part of the demand management strategy incorporated in programs supported by Fund resources. The objective is to set a target (or ceiling) for the rate of growth of bank credit that is consistent with the program's objectives for real economic growth, inflation, and the country's external payments position. Of course, there are numerous uncertainties in arriving at monetary targets. The determinants of the demand for money are often not well defined; BOP forecasts can turn out to be wrong for a number of reasons—real growth can be influenced by nonmonetary developments (such as weather conditions) and so on. Nevertheless, it is clear that some judgment must be reached.

Adjustment programs also normally include a target for containing the government's budget deficit. This target is employed because the fiscal deficit is an important determinant, in its own right, of the level and structure of demand and also because official borrowing to finance the deficit can put pressure on the availability of funds for the private sector. Broadly speaking, fiscal targets are arrived at by taking the overall rate of credit expansion compatible with the objectives of the program and determining the needs of the nongovernment sector for the desired level of output and investment. What remains is the volume of bank credit that can be used by the government without preempting productive nongovernment borrowing.

Setting fiscal and monetary targets is only the first stage in establishing a set of demand management policies. To give such targets credibility, it is usually necessary for specific measures to be implemented (or at least decided on) before a program is presented for approval by the Fund's Executive Board. In the fiscal area, such measures might include the introduction of new taxes, the raising of tax rates, or constraints on spending authority under the government budget. When such measures are adopted, the Fund staff reviews the fiscal prospects with the authorities so that it can be in a position to report to the Board that the budgetary estimates are realistic and achievable. In the monetary area, it is more difficult to specify in advance the particular measures that will be used to limit credit growth, but the authorities usually indicate a willingness to use policy instruments such as interest rates, open market operations, and credit guidelines to restrain financial aggregates within the targets that have been set.

Adherence to fiscal and credit targets (usually on a quarter-to-quarter basis) is the principal monitoring instrument used by the Fund and member countries to assess whether adjustment programs are remaining on track. Programs always contain "ceilings" on overall credit expansion and bank lending to government; if these ceilings are not observed, drawing rights are interrupted unless new policy understandings are reached. Naturally, therefore, member authorities would prefer these ceilings to be relatively high, in order to give them freedom to respond to unforeseen developments. The Fund, on the other hand, has an interest in ensuring that the programs' policies can be reviewed in circumstances where its financial projections do not materialize.

There can also be divergent views on the degree of precision with which policy measures (particularly in the fiscal area) should be articulated in advance. The Fund's experience is that a program will carry greater credibility and have greater chances of success if the concrete demand management measures to be taken are clearly identified.

**Preparations by Fund staff.** The Fund is prepared to try to respond to a request for discussions on the use of its resources as rapidly as the situation requires. Prior to its departure the staff team, or "mission" as it is called in the Fund's terminology, prepares a comprehensive briefing paper that sets out the member's current economic situation, reviews recent discussions between the staff and the authorities on adjustment policies, and considers in as much detail as possible the nature and scope of the options the staff believes are open to the authorities to bring about the needed adjustment. This briefing paper is reviewed within the Fund staff to ensure both a consensus on the adjustment measures proposed and consistency with the Fund's uniform (which does not, of course, mean identical) treatment of all members. The briefing is then forwarded for review to the Managing Director, who will frequently call a meeting to discuss its contents with the mission head and other senior staff. When he is satisfied that the briefing is consistent with the guidelines established by the Executive Board, he gives it his approval, at which time it becomes the instructions under which the staff will operate.

**Negotiating procedures.** While the staff always negotiates ad referendum to the Fund's management and Board, the degree of latitude given to a mission in its brief can vary. If, as often happens, the economic information on a member country available at headquarters is incomplete or not fully up-to-date, some flexibility is needed to enable the staff to respond to the actual situation when discussions take place. Further, the policy instruments that the authorities are prepared to consider may not be precisely those that the staff is able to foresee when it prepares its briefing. Since staff missions do not normally refer to headquarters for additional instructions during the course of their work, it is important for them to have adequate discretion to respond authoritatively to proposals by member authorities, even when these have not been foreseen.

**Mission composition.** A typical mission consists of four to six economists. The mission chief is usually a senior staff member of the area department concerned, and he is accompanied by one or two staff members from that department who specialize in the
and, as far as possible, implemented at an early stage. While recognizing this, member countries may also see an advantage in postponing politically sensitive decisions. For this reason, they sometimes would prefer their commitment to be in terms of a general undertaking to raise revenue or reduce expenditures by a certain amount.

While the Fund seeks programs that are specific in describing the policy measures to be implemented, the actual choice of measures remains that of the member. So long as the aggregate impact of the fiscal stance is consistent with the required moderation in demand, the staff is not authorized to insist on the manner in which it is achieved. In some cases, of course, member countries may seek Fund advice on particular measures, and the staff may offer suggestions on ways in which a fiscal gap could be bridged in a manner most conducive to efficient resource allocation. But it is always clear that, when questions of specific taxes and expenditures are under consideration, the staff's role is advisory and that the ultimate discretion belongs to the member.

Supply measures. In recent years programs supported by the Fund have given increased emphasis to measures aimed at developing the productive potential of borrowing members. There are several reasons for this. The large size of payments imbalances and their structural character have meant that many member countries have a large and growing external debt that can only be satisfactorily serviced if output and export growth are adequately maintained. Further, with large shifts in the terms of trade, particularly the rapid increase in the real price of energy, structural changes in production patterns in deficit countries have become even more necessary than formerly. Lastly, the fact that many Fund programs now extend over two or three years offers greater scope for supply-side measures that have an impact on economic efficiency and external performance in the medium term.

Broadly speaking, supply-side measures are aimed at improving the allocation of resources in the economy and enhancing both the quality and quantity of productive investment. By so doing, it is hoped that the underlying rate of real economic growth can be accelerated and the availability of tradable goods for export or import substitution increased. Higher growth of output and exports benefits the adjustment process in two ways. First, it will enable a given target for the current account deficit to be achieved with less sacrifice in the resources available for domestic use; and, second, it will improve the economy's debt service capacity, making possible a higher inflow of external resources.

The nature of the program measures that directly affect a country's output varies widely from case to case. Where an investment program exists, it is of critical importance, and the Fund staff collaborates closely with the staff of the World Bank in assessing whether development spending plans are consistent with aggregate resource availability and the need to build up competitive and adequately diversified export and import substituting sectors. Where changes in development policy are suggested, they are often aimed at reducing reliance on large-scale, long-gestation industrial projects (which are usually heavily dependent on imported capital equipment and intermediate inputs) and increasing the emphasis given to agriculture, infrastructure, energy, and relatively quick-yielding investments in the manufacturing sector.

Pricing policy is another area that is often carefully examined. In many countries, key prices are regulated both for social reasons and to prevent an undesirable pattern of resource use resulting from an unrestricted play of market forces. While the reasons for such price regulation are important and in many cases valid, political pressures sometimes make regulated prices inflexible in the face of inflation and changing conditions. The Fund typically stresses the advantages, if resources are to be allocated according to their scarcity, of making adequate adjustments in controlled prices; for instance, the Fund invariably urges that user prices for energy products should be raised to at least world levels. Member countries, while usually agreeing with this analysis in principle, are naturally constrained by what they perceive to be the social and political repercussions of price rises.

Programs of medium-term adjustment also frequently cover the performance of public sector enterprises and the nature of the foreign trade regime. Concerning the latter, economic performance can often be improved by increasing the availability of needed imports, exposing domestic industry to increased competition (by reducing import controls), and concentrating domestic resources in the production of those goods in which the country enjoys a comparative advantage. These considerations point toward a more "open" foreign trade country involved. In addition, there will be a staff member from the Exchange and Trade Relations Department, whose specific assignment includes work on the external trade and payments aspects of the program, and often also a staff member from another department (such as the Fiscal Affairs Department), if a particular area of economic management warrants special attention. An increasing number of recent missions have been accompanied by a staff member from the World Bank. This has been found particularly useful, and even necessary, in adjustment programs stretching over more than one year to ensure that the BOP adjustment process is consistent with such longer-term goals as improving the efficiency of domestic resource use, promoting economic diversification, and rationalizing the development program.

A mission usually remains in the field for about two to three weeks, though this timetable can vary depending on the difficulty of obtaining necessary information, the complexity of the program, and the constraints faced by member authorities in marshaling a consensus for needed adjustment measures. This latter factor not infrequently prevents full agreement being reached during a single mission. In such circumstances, discussions are adjourned, which offers the authorities of the member country the chance to reflect on the scope of an adjustment program and permits the Fund staff the opportunity to present the Managing Director with a more comprehensive picture of the latest economic developments and the authorities' thinking.

Forms of agreement. Once understandings have been reached between the staff and the authorities on needed adjustment measures, the staff assists the member country in drawing up a formal request for its use of Fund resources. The manner in which this request is presented varies slightly from case to case but, in a typical one, the Minister of Finance, on behalf of his government, will address a "letter of intent" to the Managing Director. This document, besides requesting use of resources, describes in some detail the measures that are being undertaken to improve economic and financial performance, the policies that will be followed during the life of the program, and the circumstances
Demand-switching policies. Often demand restraint alone is not sufficient to correct a serious BOP problem, and supply-side measures are, by their nature, likely to work only slowly in improving output and exports. Thus programs of payments adjustment supported by arrangements with the Fund usually involve measures with a more direct effect on the balance between external receipts and payments. Theoretical considerations, as well as a considerable amount of empirical evidence, suggest that the policy instrument that has the most general and direct impact on external competitiveness is the exchange rate. An appropriate exchange rate is central to the adjustment process and to the Fund's other responsibilities, and discussions on this issue are frequently a major aspect of negotiations on a program to be supported by use of the Fund's resources.

Exchange rate policy is almost always a sensitive issue, and an exchange rate change implies consequential changes in relative prices in the domestic economy, not all of which will be welcome on social and other grounds. As a result, exchange rate policy is often one of the most difficult areas in which to reach agreement. To avoid some of the less welcome consequences of exchange rate changes, member countries sometimes prefer to use administrative means (licenses and quotas) to limit import payments or to resort to special tariffs and subsidies to help balance the external accounts. The Fund's experience, however, is that such mechanisms are less efficient, in an economic sense, than a straightforward exchange rate adjustment. They tend to interfere with efficient resource allocation, hamper economic growth, and can usually only postpone a direct change in the exchange rate.

Where a rate adjustment appears warranted, a judgment must be reached on the size of the required realignment and the manner in which it is to be brought about. The staff attempts to calculate how the demand for and supply of exports and imports will shift as the exchange rate changes, and it supports this analysis with a calculation of the extent to which domestic and international costs of production have diverged since some equilibrium base period (although information and techniques available seldom permit a very precise calculation of the size of the adjustment required). Where feasible, the profitability of export and import-competing sectors is assessed.

Sometimes, a comprehensive study is undertaken by the Fund staff in conjunction with member authorities in an effort to establish a common analytical framework and begin a dialogue aimed at reaching agreement on a suitable rate. In some cases, an exchange rate change is postponed pending completion of this process, with the provision that suitable understandings be reached during the life of the program. In cases where a member has a complex exchange system, with different rates for different transactions, a gradual adjustment can be brought about by a phased shifting of transactions from one rate to another. The ultimate objective, however, is usually a unified exchange rate at a realistic level. In still other cases, phased adjustment may be achieved through a series of rate adjustments, a crawling peg, or temporary or permanent floating of the exchange rate.

Preconditions, performance criteria, and review clauses

An essential aim of programs in the upper credit tranches is to provide the Fund with the assurance that its resources are being used to support needed adjustment.
commitment to the adjustment process is weak. Such measures may include, depending on the circumstances, exchange rate action, interest rate adjustment, or fiscal measures designed to help bring about the needed budgetary improvement.

In addition, Fund programs in the upper credit tranches always include "performance criteria" that if not met, result in an interruption in the member's right to make subsequent drawings under the arrangement. To avoid undue detail constraints on the member's internal policymaking process, and to obviate the need for fine judgment by Fund staff, performance criteria are rather general in character and few in number. They typically include quarterly ceilings on the rate of overall bank credit expansion in the economy and subceilings on the amount of such credit absorbed by the government (or by the public sector). In addition, there is usually a limitation on the contracting of external debt guaranteed by the government. Beyond these ceilings, there are a number of qualitative performance criteria dealing with the member's intention not to introduce or intensify restrictions on payments, or bilateral payments arrangements, with other members.

If one or the other of the performance criteria is not observed, the Fund staff hold consultations (often involving a staff visit) with the member on the reasons. If the excess over a ceiling is small and technical in character and does not invalidate the objectives of the program or cast doubt on the attainability of subsequent ceilings, a "waiver" may be recommended to the Board. If approved, this restores the member's drawing rights. If the excess is more substantial and suggests that the member may experience difficulties in meeting the objectives of the program, the staff will begin discussions on the kind of measures needed to reestablish the momentum of adjustment. Following agreement on such measures, the staff will present modified performance criteria to the Board, which, if approved, similarly restore the member's drawing rights under the arrangement. Where no such agreement can be reached, the program remains inoperative and the member's drawing rights are in abeyance. Usually, if agreement is not reached on modifications that enable the basic goals of a program to be preserved, and if it remains inactive for a protracted period, the staff would suggest to a member that the original program be canceled or allowed to lapse and efforts be directed instead toward the formulation of a new program to take account of new circumstances.

"Review clauses" cover policy adjustments that may need to be made during the life of a program but that cannot be seen with clarity when the program is formulated. In this connection, mention has already been made of the exchange rate. It may also be that the budget year does not coincide with the period covered by the arrangement, in which case it may be necessary to make suitable fiscal measures subject to a review clause at the time the budget is introduced.

The review clauses just mentioned are performance criteria in the sense that drawings cannot continue unless policy understandings between the Fund and the member are reached at the time of the review. In addition, all programs contain provision for periodic (normally semianual) consultation and review. Such consultation and review need not involve a requirement to reach policy understandings but are simply to provide the Fund with an opportunity to consult with the member on the implementation of the program.

One-year, multiyear programs

A financial program normally covers a period of 12 months, since such a period corresponds best with the financial planning horizon of monetary authorities. However, as already noted, a number of arrangements have been established in support of adjustment programs extending over two or three years. This raises the question of the relationship between the longer-term adjustment program and the annual financial program.

In a typical three-year stand-by or extended arrangement, the authorities indicate not only the structural measures they intend to introduce over the program period but also their demand management strategy. This may involve, for example, a gradual but sustained reduction in the fiscal deficit and a deceleration in the rate of growth of the money and credit aggregates. For the first year of the program, concrete measures to set this process in train would be described and reflected in precise targets or ceilings for the financial aggregates involved. For subsequent years, the policy description is usually at a more general level, covering, say, the intended size of the fiscal deficit and rates of growth of aggregate revenues and expenditures but not involving commitments to specific actions in the revenue and expenditure fields. At the beginning of the second and third program years, a detailed financial program for the ensuing 12-month period would be drawn up, with quantified fiscal and monetary targets.

**Overview**

It is clear from what has been said in this article that the economic policy measures involved in programs supported by the Fund's resources are difficult and politically sensitive. Yet, it must be recognized that, with or without the Fund's involvement, the process of restoring a viable external position is likely to involve painful adjustments to existing economic structures. The need for the kind of BOP financing the Fund provides to be accompanied by effective action to remove the basic sources of disequilibrium is rarely questioned. Of course there can be, and frequently is, disagreement regarding the nature of the precise policies to be adopted in individual circumstances. The Fund attempts to be flexible in this regard: matching the content of adjustment programs to the circumstances of individual members, while attempting to ensure that the momentum of adjustment is adequately sustained. The evolving nature of Fund programs is a reflection of this attempt to incorporate the lessons of experience into the current practice of the institution.

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**Related reading**


A review of the Bank's efforts to reduce poverty and stimulate growth during the 1970s leads to endorsement of these dual objectives and some suggestions for future Bank programs.

The World Bank has always emphasized economic growth and efficiency. In the 1970s, however, as part of a growing worldwide recognition that growth was not reaching the poor majority in many developing societies, the Bank in addition placed special emphasis on direct measures to alleviate poverty, in both its lending operations and its economic research and analysis. An internal review of the Bank's experience with this approach has recently been completed (see box). This article summarizes the findings on three main questions: What changes have occurred in Bank activities as a result of the effort to reduce poverty? Have projects supported by the Bank been cost-effective in benefiting large numbers of poor people, in ways consistent with efficient growth? How should policies on poverty alleviation respond to changing pressures in the 1980s?

Changes in activities

During the 1970s, it was World Bank policy to use its funds to raise the productivity and living standards of the poor. The International Bank for Reconstruction and Development (World Bank) and the International Development Association (IDA) commitments to the countries where most poor people live—those with per capita annual incomes below US$680 in 1979—increased from 37 per cent of the total program through 1968 to 58 per cent in the 1979-83 program. IDA now lends only to this group (see Table 1).

The Bank has also increased its lending for sectors and subsectors widely considered to offer the most direct benefits to the poor—notably rural development, primary education, small-scale industry, water supply and waste management, and population, health, and nutrition. These sectors' share of Bank/IDA lending increased from 5 per cent in 1968-70 to 30 per cent by 1979-81 (see Table 2). Within sectors there were also changes: rural development loans (over half of whose benefits reach the rural poor) increased from 21 per cent of all agricultural lending in 1969-73 to 53 per cent in 1978-81. Bank research and analysis, by the latter part of the 1970s, was increasingly concentrated on poverty issues. Meanwhile, methods to measure the extent of poverty and the impact of development on the poor, while still crude and in need of improvement, became an important tool in helping to focus the lending program on direct poverty alleviation.

Impact of new policies

The evidence indicates that projects with particular emphasis on poverty have benefited large numbers of poor people and have had good economic rates of return. There are, of course, unsuccessful projects; but the proportion is small and no higher for poverty-focused projects than for others.

The Bank's independent Operations Evaluation Department (OED) also reports that poverty projects have similar appraisal times, implementation delays and problems, and cost overruns. They also absorb similar amounts of Bank supervision time per project or per beneficiary—although they have taken more time per dollar loaned, as early new-style projects were often relatively small, pilot efforts. In general, the Bank has benefited from extensive "learning by doing"—from both successes and failures—which should help efforts to
In September 1981 the World Bank established a task force of senior staff to review the Bank's approach to poverty alleviation. The group included Leif Christoffersen, Anthony Churchill, Aklilu Habte, Mahbub ul Haq, Basil Kavalsky, Herman van der Tak, Bevan Waide, and Hollis Chenery, Chairman. The task force was assisted by Norman Hicks, Michael Lipton, and Alexander Shukow.

Bank management and the Executive Directors at a Board seminar have generally endorsed the conclusions of the task force report. In a recent speech in Lagos, Nigeria, Bank President A. W. Clausen emphasized that "a key and central aim for the Bank is the alleviation of poverty. Our objective in any developing country—anywhere in the world—is precisely the same: to assist the country both to accelerate its economic growth and to reduce its level of domestic poverty by enhancing the productivity of its poor, and thus making possible a better standard of living for all its people."

reduce poverty and stimulate growth in the 1980s.

Agriculture and rural development are central to poverty alleviation. In developing countries, some 70 per cent of the total number of poor depend on farm incomes, and a similar percentage of poor people's income is spent on food; yet typically rural productivity—and incomes-per-head—are only 30-40 per cent of urban levels. Lending for rural projects increased dramatically in the 1970s—from $2.6 billion in 1969–73 to over $13 billion in 1978–81. A rising share of this total supported the poorest countries and/or crops most likely to be grown or eaten by the poor.

Projects approved since 1974 were thought, at the time of appraisal, to be likely to benefit about 125 million poor people. Recent OED audits of completed projects suggest this estimate may be exceeded. As for the cost, rural development projects audited in 1979 benefited 660 small farmers for every $1 million loaned (at a cost of $1,500 per farmer), compared with 47 farmers per $1 million (at $21,000 per farmer) in other agricultural projects.

Emphasis on small farmers has seldom conflicted with economic and financial efficiency; audits show that average rates of return on poverty-oriented rural development projects were at least as good as those on other agricultural projects. Small farmers also appear able to obtain higher returns on investment and to default on loans less often. This confirms other evidence that small farms usually achieve greater annual employment and output per acre than larger farms.

Some difficult problems remain. First, low-risk technical "packages" appropriate for poor farmers in semi-arid rainfed areas, particularly in Africa, are not readily available. In irrigated areas, inadequate or corrupt water delivery practices often deny water to poor and downstream farmers.

Second, the Bank's rural development strategy seeks mainly to raise the productivity of its poor, and thus reduce poverty and stimulate growth in the 1980s. Emphasis on small farmers has seldom conflicted with economic and financial efficiency; audits show that average rates of return on poverty-oriented rural development projects were at least as good as those on other agricultural projects. Small farmers also appear able to obtain higher returns on investment and to default on loans

## Table 1

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<tr>
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*Source: World Bank.*

## Table 2

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<td>Industry (including development finance companies)</td>
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<td>16.4</td>
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<td>13.8</td>
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<td>15.9</td>
<td>13.4</td>
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<tr>
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<td>$7,369.9</td>
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*Source: World Bank.*
Urban poverty projects. It is harder to affect poverty by increasing the productivity of the poor in towns, where investments in industry, power, and transport are often efficient only on a large scale, and not especially focused on either employment or poverty. Recognizing that the urban poor often cannot afford housing and services, the Bank has, since 1972, strongly endorsed an innovative approach to provide "sites and services" instead of structures. This has evolved to include upgrading squatter settlements, which reached far more people per dollar, and avoided ineffective and unpopular slum clearance by bulldozers.

These urban programs involved secure land tenure, affordable design, consumer payment for services to enhance replicability, and self-help labor. Bank urban programs have also come to include low-cost transport and city-wide investment programs. They have strengthened local institutions and gained acceptance for new approaches for national programs to increase the efficiency of cities. Government policies toward the provision of urban services have improved in some 35 countries as a result of Bank assistance, which has demonstrated that it is possible to provide affordable services to the poor.

Since 1972, 52 Bank projects centered on urban shelter have involved $1.6 billion of Bank/IDA funding and $2 billion of borrower government and other financial. Appraisals anticipated some 11 million beneficiaries—with over 55 per cent of project costs benefiting the poor—and real economic returns averaging 20-25 per cent. Evaluations of completed projects are few, but they too suggest high returns, good cost recovery (66-95 per cent), and success in reaching the poor. Bank projects initially concentrated on owner-built housing, but now increasingly encourage owners to hire construction labor and rent out rooms, helping to spread benefits to those too poor to own even low-cost housing.

It is evident that better urban shelter is needed—and that the poor are frequently willing to pay for it. A central problem remains: how, once decently housed, can the urban poor use these programs to expand income from work? Greater emphasis on small-scale, labor-intensive enterprises may well be required. The smallest, in particular, can be an effective and economical way to increase productive employment.

With low cost per job as an important selection criterion, Bank/IDA loans to small firms have grown from almost none before 1974 to 2 per cent of lending by 1980-81. Based on problems experienced in early projects, the Bank has shifted toward more ample, unsubsidized credit, smaller enterprises, and recommending the elimination of policies favoring large, excessively capital-intensive enterprises.

Another area important to poverty alleviation is water supply and waste management, which now receive over 6 per cent of Bank lending. Due to the use of simpler, innovative technologies and pricing procedures, these projects reach very large numbers of mostly poor beneficiaries—although, by value, most benefits go to the urban nonpoor, who create the vigorous pressure that attracts public funding. In this sector, with small enterprises, very few Bank projects have thus far addressed rural needs.

Social sectors. Research and experience provide increasingly strong evidence that gains in productivity from investments in primary education, family planning, basic health care, and nutrition make them worthwhile on economic, as well as humanitarian, grounds.

About 5 per cent of Bank lending is for education, some 40 per cent of it financing primary education (compared with near zero in 1969). Primary education generally shows higher economic returns than other forms of education. Since the better-off are usually already in primary school, such expansion benefits mainly the poor, but the rapid pace may sometimes sacrifice quality; recent projects, notably in textbook distribution, attack this problem. The timing, location, and cost of schooling greatly affect poor families' demand for it; prospects for some cost recovery, along with general improvements in revenue, influence governments' readiness to supply it. The Bank's work on project design in these matters has helped increase school attendance among poor families. Recurrent cost control will be especially important as budgetary constraints become even tighter for developing countries in the 1980s.

Despite the importance of population, health, and nutrition to broadly based poverty alleviation, these areas still absorb less than 1 per cent of the Bank's total lending program. The alleviation of poverty is closely linked to reductions in population growth rates. Several countries have made encouraging progress through a combination of more effective economic development programs and increased access to family planning services, but in most only a small percentage of fertile couples practice family planning. In Africa, few countries have even rudimentary programs; moreover, the growth of food production has fallen behind increases in population. Only $400 million in population loans were made to 13 countries in the 1970s, reflecting the fact that the Bank has not found this an easy area in which to work. The Bank's investments in agriculture, education, and other sectors can also strengthen the role of women in development and help reduce fertility, but these indirect approaches will not fund the increased access to services that is so necessary. Given the large size of most poor families, returns to investment in preventing births are very high, with major gains for the poorest.

In the 1970s, the Bank's lending for health was a component of projects in other sectors; only recently have separate health projects been started. These projects and associated policy and institution-building activities will be an important part of future programs, given the demonstrated contribution of improved health to labor productivity and the well-being of the poor.
particularly with the Bank’s emphasis on primary health care and preventive measures.

Multisectoral nutrition projects have been hard to administer. However, persistent Bank project and policy work has led to some replication and has raised the priority of nutrition in the national policies of several countries.

**Impact on growth.** The Bank’s strategy in the 1970s supported many projects that benefited the poor, both directly and through some local replication. Poverty-alleviating agricultural and urban projects showed good returns; much investment in human capital has paid off as well.

The macroeconomic evidence also suggests large areas of complementarity between growth and poverty alleviation. However, the wide variety of country experience provides little guidance on the ideal balance to achieve both objectives. At the extremes there is surely a trade-off. Massive social expenditures can undercut investment, and thus jeopardize sustainable economic growth; unlimited emphasis on growth can leave too few resources to improve poor people's living standards. In general, countries that have placed special emphasis on poverty alleviation have also been able to achieve average or somewhat above average growth rates.

**Emphasis for the 1980s**

In some countries the incidence of poverty fell sharply in the 1970s, and poverty alleviation policies can take some of the credit. But massive poverty persists. Further improvements based on the lessons of the past are needed, especially because the difficult circumstances of the 1980s present the poor with greater problems and increased risks.

The “oil price shocks” of the 1970s (real oil prices, despite the recent decline, remain six to seven times higher than in 1972), slower world growth, and the increasing costs of financing development compound the difficulties of alleviating world poverty. Developing countries need to improve their utilization of energy and to achieve the structural adjustment of their economies in an environment where protectionist trade measures and scarcer and/or costlier inflows of capital threaten the resources and concern previously devoted to poverty questions.

These circumstances heighten pressures to turn away from balanced development programs where growth and poverty alleviation are pursued together. Resource constraints create a crisis atmosphere where budgetary choices tend to stress the reduction of current-account and public-sector deficits at the cost of longer-term investments in, say, agriculture and education. In these circumstances, the real trade-off may be between short-term balance and both poverty alleviation and growth, with poor people in the poorest countries suffering lasting damage. Increased flows of external assistance for these countries can help cushion the worst effects of a painful short-term trade-off, but prospects for substantial additional concessional resources in the near term are not encouraging.

There are many ways in which the alleviation of poverty can be addressed and individual decisions on projects and programs will need to be made in the context of each government’s circumstances and policies. The Bank, however, should seek to minimize the damage to poverty programs, and should encourage the efficient use of resources to protect and enhance the productivity and living standards of the poor.

The Bank can work with individual governments to develop specific programs and policies in which long-term growth and poverty alleviation are complementary. More attention should be paid to the impact of country and sectoral policy options on these dual objectives. Structural adjustment programs should consider, as far as possible, how the burdens of adjustment are shared among income groups, and how adverse effects on the poor—for example through increased unemployment, higher prices of basic goods, or higher taxes—can be mitigated. Research should give high priority to reducing the gaps in our knowledge of the effects on the poor of macro policies, including alternative routes toward structural adjustment.

Declining IDA resources may unavoidably cut total lending to the poorest countries. However, as experience shows that projects in rural development, urban shelter, primary education, and health produce high returns, a strong argument can be made that scarcer IDA resources should, wherever possible, be even more firmly directed toward projects meeting both efficiency and anti-poverty objectives. Wherever feasible, poverty and employment aspects should also be considered in the design of projects in the traditional sectors, for example, power, transport, and industry. It is misleading to suggest that only a handful of sectors can benefit the poor.

It has proven extremely difficult to benefit people without productive assets—for example, the rural landless, the urban jobless, adult illiterates, or female-headed households. In addition to continued support for education, population, and health programs, greater efforts should be made to understand how the productivity and employment of such people can be increased, including further experiments in designing projects that benefit the poorest families.

Better analysis of the social environment of a project, assessment of its likely social impact, and increased technical assistance are important to lasting and successful development activities. Projects are more likely to benefit the poor to the extent they improve administration and management, and build a strong institutional base that will endure after the project is completed.

A balanced strategy of growth combined with poverty alleviation provides the best general framework for development in the 1980s. There is no panacea in this approach, nor will it lead to precise answers for each country’s specific needs. No development strategy does. What it does is to provide a viable and sensible starting point for making critical decisions. The Bank’s task is to build on the experience of the 1970s and to strengthen the approach that now underlies its program.
Education and national development

How does education serve to promote the economic and the sociocultural development of developing countries? The Director of the Education Department reflects on World Bank lending for education projects in the light of diverse national objectives.

Aklilu Habte

Developing countries spend an increasing proportion of their scarce resources on education. Through education they seek, first, to follow the traditional path to "development" by strengthening their national capacity to acquire scientific knowledge and thereby better their economic performance. Second, they use schooling in some instances to create and in others to preserve a sense of national identity and independence that incorporates their cultural values, retaining the freedom to select different elements from foreign systems. So education is not just a means to economic development, measured by discount rates, rates of return, and so on. It has also a broader sociocultural dimension that needs to be taken into account when measuring its role in national development. The success or failure of education systems, therefore, in large part depends on the relevance of development programs to the overall needs of national societies.

The need to preserve a diversity of cultures and values is particularly urgently felt in many developing countries. Most nations, even those whose independence preceded World War II, have been heavily influenced by metropolitan models. In some, school structures, curricula, and credentials, as well as legal and administrative systems, were transferred directly. In others, such as my own country (Ethiopia), the influence was less direct. But the result is a powerful pressure to make cultures the same the world over and to multiply identical beliefs and behavioral patterns just as industrial artifacts or airport facilities are.
the same the world over. A certain diversity is lost, and it is not surprising that most developing countries regret this loss and want to use their education system to preserve something of their own culture.

They also need to use it to acquire, produce, and impart scientific skills and knowledge. In general, a local scientific capacity is essential to interpret and absorb foreign technology; any nation without some capacity for this function will suffer. It is also needed to avoid counterproductive activities—to know the degree to which mining waste will affect a fishing industry; the degree to which meatpacking industries hold true to their product labels; and the degree to which social programs are as economic—and as social—as their claims. As the World Development Report, 1980 aptly stated, people who are illiterate or who are scientifically ignorant or unaware of a wider world remain essentially "untapped and are unable to contribute fully to national development."

Yet education is expensive, not only in terms of direct costs but also because of wasted resources. In many countries the environment does not encourage children to complete their educational programs. Speaking of the characteristics of primary education in one West African country, a United Nations Educational, Scientific and Cultural Organization (UNESCO) document stated:

Primary education accounts for 94 per cent of the total school enrollment...occupies about 90 per cent of all teachers, consumes 62.4 per cent of the public educational budget, covers only 13 per cent of the relevant age group, permanently carries 25 per cent of the repeaters, and has an output of 28 graduates for an input of 100 new entries at a cost of 19 pupil years.

Acknowledging the need for education as a central element for growth, this article will review the Bank's experience with lending for education since 1963. Reflecting the diversity of its members' needs, the Bank's funds have been used in many ways—from providing more school places to developing computer facilities and teaching women about nutrition and family planning. Although the Bank lends generally for projects that show economic rates of return, the diversity of its lending reflects its concern for strengthening all aspects of human and social development. Many problems have arisen in the course of this work: expanding school systems often meant great strains were placed on budgets to pay teachers' salaries; providing technical equipment meant that it had to be maintained; and there has been too much preoccupation with single projects and too little with the long-term needs of individual countries. On the other hand, the Bank's investments in secondary schools, for instance, have shown remarkable resilience in the face of political and economic disturbances, indicating the strength of the demand for them and proving their effectiveness. For it is widely recognized that a solid educational system goes a long way toward explaining a country's success in developing productive resources and in preserving its sociocultural uniqueness.

**The role of the Bank**

There is no single lending priority in the Bank's education sector. Any area of human capital—whether in formal or nonformal institutions, or in any area of management, administration, information diffusion, processing, or research capacity—is a candidate for financing. The strategy for each country is determined, as much as possible, independently and is based upon five broad principles: (1) expansion of basic education; (2) reduction of educational inequalities; (3) improvements in the cost-effectiveness of the transfer of knowledge; (4) provision of required manpower skills; and (5) development of national analytic capacities in management, administration, and planning.

Although exceptions are made, in general the emphasis in low-income countries is on the development of low-cost basic education to lay the requisite foundation of science, language, mathematics, and other cognitive skills. In middle-income countries, where first-level education is already widely available, educational quality is emphasized, and with it the expansion of facilities to meet the needs of an increasingly sophisticated economy. As the absorptive capacity of an economy grows, the priority tends to shift toward providing higher level technical skills, as well as developing skills in science, technology, information processing, and research.

One of the strengths of the Bank, which could hardly be equaled by other inter-

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**Table 1**

<table>
<thead>
<tr>
<th>Institutions assisted by World Bank education projects, 1963–81</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Level</strong></td>
</tr>
<tr>
<td>-------------------</td>
</tr>
<tr>
<td>Primary</td>
</tr>
<tr>
<td>Secondary</td>
</tr>
<tr>
<td>Postsecondary</td>
</tr>
<tr>
<td>University</td>
</tr>
<tr>
<td>Agriculture</td>
</tr>
<tr>
<td>Engineering</td>
</tr>
<tr>
<td>Forestry</td>
</tr>
<tr>
<td>General university assistance</td>
</tr>
<tr>
<td>Health science</td>
</tr>
<tr>
<td>Home economics</td>
</tr>
<tr>
<td>Law/administration</td>
</tr>
<tr>
<td>Physics/chemistry</td>
</tr>
<tr>
<td>Social science</td>
</tr>
<tr>
<td>Technical/commercial</td>
</tr>
<tr>
<td>Nonuniversity institutes</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Education area</strong></th>
<th>Number of Student Places</th>
<th>Number of Institutions Assisted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Administration/management</td>
<td>3,640</td>
<td>14</td>
</tr>
<tr>
<td>Agriculture</td>
<td>13,075</td>
<td>81</td>
</tr>
<tr>
<td>Computer</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Food processing training</td>
<td>960</td>
<td>2</td>
</tr>
<tr>
<td>Forestry</td>
<td>236</td>
<td>4</td>
</tr>
<tr>
<td>Health</td>
<td>1,798</td>
<td>130</td>
</tr>
<tr>
<td>Merchant marine</td>
<td>520</td>
<td>5</td>
</tr>
<tr>
<td>Operational engineering</td>
<td>3,320</td>
<td>6</td>
</tr>
<tr>
<td>Recurrent training (multicurricular)</td>
<td>1,500</td>
<td>3</td>
</tr>
<tr>
<td>Technical</td>
<td>66,672</td>
<td>140</td>
</tr>
<tr>
<td><strong>Teacher training</strong></td>
<td>132,142</td>
<td>651</td>
</tr>
<tr>
<td><strong>Primary</strong></td>
<td>13,297</td>
<td>478</td>
</tr>
<tr>
<td><strong>Secondary</strong></td>
<td>7,689</td>
<td>159</td>
</tr>
<tr>
<td><strong>Postsecondary</strong></td>
<td>9,980</td>
<td>11</td>
</tr>
<tr>
<td><strong>Multilevel</strong></td>
<td>1,176</td>
<td>3</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>2,640,952</td>
<td>21,053</td>
</tr>
</tbody>
</table>

Source: World Bank Education Department.

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national development institutions, is its wide experience and its concurrent involvement in a number of development sectors within the same country. This is because development has to be conceived at a multisectoral level no less for an education loan than for a power project. Many factors contribute to a person’s growth—among others, income, education, health, nutrition, and fertility.

In the past 18 years, the education sector has helped to create 2.6 million new student/trainee places in approximately 21,000 educational institutions, including 185 university faculties, 651 teacher training colleges, 2,903 secondary schools, and 16,902 primary schools (see Table 1). Eighty-seven countries have requested capital for educational projects, amounting to approximately US$4 billion, with—including national or other external resources—a total project cost of $8.1 billion. But the Bank’s education sector is not only concerned with places in schools: 26 projects have helped to establish research and product-testing facilities; 10 have partially funded radio or television broadcasting facilities; and 7 have assisted the development of computer facilities. Assistance has been provided in a number of areas: mechanical engineering (48 projects), fisheries (19 projects), forestry (18 projects), child care (12 projects), and hotel and restaurant management (4 projects) (see Table 2).

The Bank channels its education loans/credits in three principal ways:

- Through direct loans for the education sector, which range from the most general types of formal schooling to the most specific kinds of nonformal teaching; from the simplest levels of education to the most advanced postgraduate specialties.

- Through project and sector-related training—that is, through loans either in education or in sectors such as power and transportation, which include the training of managers and persons to operate and maintain project equipment and machinery. The training of over 2,000 persons by the Training Institute of the Bolivia Railway Project, the training of over 5,000 farmers in carefully organized cooperative training sessions of the Lofa County Agricultural Project in Liberia, and the development of the Kenya Water Resources Training Institute in the Fifth Education Project of Kenya are illustrative of the multitude of project components under execution.

- Through education components within urban and rural development projects. Thus, several rural development projects in Northeast and Central Brazil and elsewhere contain components designed to improve access to and the quality of schools for rural children. Similar efforts to improve the skills of the urban poor are being attempted through projects in Colombia, India, Kenya, and elsewhere.

Problems; successes

A decade ago, a “good” educational system was interpreted to mean one that provided effective teacher training and sound curriculum development, the latter often being reduced to making the content and delivery of what was taught more “practical.” However, the purposes of practical curricula—which taught metal work and carpentry, for example—were not always well accepted, well defined, or well implemented. And quality itself is a broader concept than previously recognized. It includes all elements—chalk, maps, furniture, textbooks, and visual media—required for increased learning; and it requires the measurement of what has been learned. These pose new problems. Specific efforts to strengthen science teaching by placing laboratories in educational institutions often ran into difficulties because of the complexity of upkeep in an environment where chemicals, propane gas, and other ingredients required for demonstrations are at a premium and the supply irregular. Maintenance of equipment has also been a problem, as has, more generally, the strain on governmental finances in meeting the costs of teacher salaries resulting from educational expansion.

And there have been problems coordinating training among sectors within both national and international agencies. Duplication of effort is too common. Protracted problems—such as equipment maintenance—have often been under-
lending for training, too, has increased its share in total Bank/International Development Association loans from 1.1 per cent to 1.4 per cent between 1976 and 1980. The success of economic development across sectors is significantly helped by a firmly founded education system. Strengthening that foundation is our principal purpose. What Alfred Marshall wrote is more true today than it ever was, “Knowledge is the most powerful engine of production.”

**Education and culture**

That certain educational investments (although not all) are able to withstand the vicissitudes of economic and social change is simply an indication of the consistency of what economists call “social demand” and what I would call the aspirations of people the world over for knowledge. The purpose of the Bank—in any of its sectors—is to change people’s lives for the better. As a bank we must weigh the economic alternatives of how to do this, and for the most part our analyses, by virtue of the nature of the institution, are confined by the concept of what is most economic. But economics itself is an instrument; it is no more and no less than a scientific measure of the options nations have to select from. What they actually want is a wider scope for choice.

There are two reasons why nations want to borrow for education; these have already been mentioned, but it is relevant to discuss them in more detail. First, most want their own capability, at the very least, to interpret for themselves the pluses and minuses of various ideas—technological, religious, or political—and to partake not only in the application but also in the generation of knowledge among the community of nations. Second, they want education to discover and sustain the fundamental values of their own culture and subcultures. People’s values are unique. They may, for instance, be deeply religious. They may believe in the importance of the family, in the virtue of true courage, in civility, in the dignity of the individual, and in the wisdom of age and experience. Their historic music, poetry, and painting are similarly unique. But the arts of the nation and many other traditions, many of them oral, will soon be lost if they are not recaptured in more enduring forms.

That is why nations continue to be preoccupied with setting up institutions and encouraging researchers, local or otherwise, to record their histories in books; collecting and preserving their oral traditions, which include the production of textbooks and the experience acquired over the past several development decades. The next two to three development decades will perhaps reap the fruits, and benefit from the lessons learned and the experience acquired over the past several development decades.

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**Table 2**

<table>
<thead>
<tr>
<th>Curriculum components in World Bank education projects, 1963–81</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Component</strong></td>
</tr>
<tr>
<td>-------------------------------------</td>
</tr>
<tr>
<td><strong>Cognitive skills</strong></td>
</tr>
<tr>
<td>Bookkeeping/accounting</td>
</tr>
<tr>
<td>Economics</td>
</tr>
<tr>
<td>General science</td>
</tr>
<tr>
<td>Mathematics</td>
</tr>
<tr>
<td>Reading, writing</td>
</tr>
<tr>
<td><strong>Engineering</strong></td>
</tr>
<tr>
<td>Engineering—automotive</td>
</tr>
<tr>
<td>Engineering—chemical</td>
</tr>
<tr>
<td>Engineering—civil</td>
</tr>
<tr>
<td>Engineering—electrical/electronics</td>
</tr>
<tr>
<td>Engineering—mechanical</td>
</tr>
<tr>
<td>Engineering—mining</td>
</tr>
<tr>
<td><strong>Health</strong></td>
</tr>
<tr>
<td>Child care</td>
</tr>
<tr>
<td>Family planning</td>
</tr>
<tr>
<td>Food processing</td>
</tr>
<tr>
<td>Health/nutrition</td>
</tr>
<tr>
<td>Paramedical</td>
</tr>
<tr>
<td><strong>Management</strong></td>
</tr>
<tr>
<td>Computer and data processing systems</td>
</tr>
<tr>
<td>Foreman training</td>
</tr>
<tr>
<td>Hotel/restaurant management</td>
</tr>
<tr>
<td>Industrial management</td>
</tr>
<tr>
<td>Management</td>
</tr>
<tr>
<td><strong>Rural development</strong></td>
</tr>
<tr>
<td>Agroindustry</td>
</tr>
<tr>
<td>Community development</td>
</tr>
<tr>
<td>Cottage industry</td>
</tr>
<tr>
<td>Farm mechanics</td>
</tr>
<tr>
<td>Fisheries</td>
</tr>
<tr>
<td>Forestry</td>
</tr>
<tr>
<td><strong>Small industry</strong></td>
</tr>
<tr>
<td>Carpentry</td>
</tr>
<tr>
<td>Construction—building</td>
</tr>
<tr>
<td>Forging, welding, pipe fitting</td>
</tr>
<tr>
<td>Galvanizing/plumbing</td>
</tr>
<tr>
<td>Industrial production</td>
</tr>
<tr>
<td>Masonry</td>
</tr>
<tr>
<td>Mechanics—auto</td>
</tr>
<tr>
<td>Mechanics—diesel</td>
</tr>
<tr>
<td>Metalshop/construction</td>
</tr>
<tr>
<td>Shipbuilding</td>
</tr>
<tr>
<td>Textile technology</td>
</tr>
<tr>
<td><strong>Other</strong></td>
</tr>
<tr>
<td>Electrical installation</td>
</tr>
<tr>
<td>Electrical power</td>
</tr>
<tr>
<td>Petrochemical/petroleum</td>
</tr>
<tr>
<td>Refrigeration/air conditioning</td>
</tr>
<tr>
<td>Telecommunications</td>
</tr>
</tbody>
</table>

Source: World Bank data

1. Each education project is preceded by an appraisal report that describes the project’s major emphases. These descriptions frequently include mention of the programs being sponsored within the institutions assisted under the project. When these curricula are mentioned specifically in project appraisal reports, they are coded. This is a list of the frequency with which curricula are mentioned. A total of 224 projects were approved in 1963–81. They are grouped roughly according to area of economic activity for ease of interpretation.

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Related reading


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How the concept of ECDC evolved into a program that is being negotiated internationally. The author reviews the principal issues and proposals, including one suggested scheme that could be successfully negotiated—the Global System of Trade Preferences. He concludes that implementation of the many proposals being discussed will be a long-term project.

**Jack P. Barnouin**

The need for strengthening economic cooperation among developing countries (which has come to be known as ECDC) has been increasingly recognized by the international community in recent years (see box). Although global cooperation among developing countries has only recently been the focus of international discussion, the concept in itself is not a novel one. As the box shows, regional attempts to implement it may be traced back to the early 1960s. But while these were based on the concept of cooperation, the early efforts were considerably more limited in scope and content than the new approach favored now by the Group of 77 (developing countries). First, they embraced regional and subregional groupings of countries while the new approach involves all developing countries. Second, the regional agreements were concerned with trade, and the new approach is geared toward forging links not only in trade but also in a large number of other areas. Finally, while regional integration efforts had relied only to a limited extent on the support of the United Nations system, mainly through the United Nations regional commissions, the sponsors of the new approach have called for broader involvement of existing international institutions.

**Rationale**

This article will attempt to identify the principal efforts at regional and multilateral economic cooperation among developing countries, as an adjunct to their economic ties to the developed countries. The aim is to provide a concise outline of the discussions to date and the prospects for implementing certain policies, especially in the area of trade. Data on trade flows accompany this article.

Two major factors may explain the recent shift among the Group of 77 toward efforts at global cooperation. First, with a marked slowdown in the expansion of South-North trade as a result of the reduced rate of economic growth in the industrial countries, the developing countries began to consider the fostering of the largely untouched intra-South trade as a major tool to maintain a relatively satisfactory rate of growth of their economies. Since they felt that, by their very nature, regional integration efforts were somewhat limited in scope, they came to the conclusion that an attempt should be made to reduce barriers against trade among themselves at the world level. A second factor has been the disappointment of the developing countries with the results of the North-South dialogue. This led them to the view that their negotiating position should be strengthened through the establishment of worldwide economic links among themselves.

These two factors are emphasized by the Brandt Commission, which defines the purpose of economic cooperation among developing countries as being to forge “links among the countries of the Third World for more fully exploiting their potential for economic and social development and for strengthening their collective bargaining capability in international economic relations.”

**Program scope, content**

The final report endorsed by the Caracas Conference in 1981 (see chronology) identifies seven sectors in which cooperation among Third World countries should be strengthened in the near future. While no specific priority is assigned to any of these sectors, the parts of the program dealing with finance, the transfer of technology, and trade are considerably more detailed...
Main elements of the international recognition of economic cooperation among developing countries

Regional phase

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1959</td>
<td>West African Customs Union begun (replaced in 1974 by the West African Economic Community)</td>
</tr>
<tr>
<td></td>
<td>Equatorial African Customs Union begun (replaced in 1966 by the Central African Customs and Economic Union)</td>
</tr>
<tr>
<td>1960</td>
<td>Latin American Free Trade Association created</td>
</tr>
<tr>
<td></td>
<td>Central American Common Market created</td>
</tr>
<tr>
<td></td>
<td>Andean Group established</td>
</tr>
<tr>
<td></td>
<td>Caribbean Free Trade Association established</td>
</tr>
<tr>
<td>1964</td>
<td>Arab Common Market established</td>
</tr>
<tr>
<td>1967</td>
<td>Association of South-East Asian Nations established</td>
</tr>
<tr>
<td></td>
<td>East African Community created (dissolved in 1977)</td>
</tr>
<tr>
<td>1975</td>
<td>Economic Community of West African States established</td>
</tr>
</tbody>
</table>

International phase

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1974</td>
<td>United Nations Sixth Special Session adopts Program of Action for establishing a New International Economic Order (NIEO), emphasizing ECDC</td>
</tr>
<tr>
<td>1976</td>
<td>Group of 77 includes ECDC program in Manila Declaration and Program of Action</td>
</tr>
<tr>
<td></td>
<td>UNCTAD IV in Nairobi approves resolution to support ECDC</td>
</tr>
<tr>
<td></td>
<td>Nonaligned heads of state adopt action program on ECDC in Colombo</td>
</tr>
<tr>
<td>1979</td>
<td>Group of 77 adopts Arusha Program for Collective Self-Reliance, which is partly endorsed by UNCTAD V in Manila</td>
</tr>
<tr>
<td>1981</td>
<td>Group of 77 in Caracas issues blueprint for ECDC</td>
</tr>
</tbody>
</table>

and specific than those dealing with other sectors, such as food and agriculture, energy, raw materials, and industrialization.

In the area of finance, the basic aim of the program is to bring about a substantial increase in the direct flow of funds from the developing countries with structural balance of payments (BOP) surpluses (the oil exporting countries) toward the rest. The program therefore recommends, inter alia, the strengthening of existing subregional and regional payment arrangements, incorporating an important element of reciprocal credits to support mutual trade flows; the examination of the feasibility for a financing facility to meet the BOP needs of developing countries with contributions from the developing countries themselves; the establishment of new regional and interregional trade development banks as well as an expansion of the activities of existing ones; and further study of the feasibility of establishing a development bank for developing countries.

The program also contemplates a number of other self-help measures. These include the increase in the deposits of governmental and semigovernmental institutions of developing countries in the banks of other developing countries; a larger participation of developing countries in the purchase of financial instruments issued by other developing countries in the international capital market; and the conclusion of bilateral and multilateral arrangements to enhance the soundness and attractiveness of direct investment by developing countries in other developing countries. Finally, the program recommends that "developing countries should intensify collective efforts in international forums to ensure that developed countries join the developing countries in establishing a mechanism to alleviate the financial burden imposed on the developing countries on account of oil price adjustment and the continued inflation of the prices of their imports of goods and services from developed countries."

Regarding technology, the program has two aims: to upgrade the collective technical capabilities of the developing countries through an exchange of experience and to improve the terms under which technology is being transferred from the industrial countries to the Third World. It recommends better dissemination of information on the technological capabilities of the developing countries, the conclusion of scientific and technical cooperation agreements among them, the pooling of information on the terms and conditions for the transfer of technology from the developed countries, and, when appropriate, joint negotiations for the purchase of specific technologies from the industrial countries.

The Caracas program makes a number of other suggestions for possible cooperation among developing countries. The most interesting of them would strengthen existing associations of raw material producers in the developing countries and establish new associations; foster cooperation among developing countries in specific industrial sectors, establishing, among others, multinational production enterprises; undertake joint efforts to explore and exploit additional sources of energy in the energy-importing developing countries; establish multinational enterprises for the production of energy-related capital goods such as drilling, pipelines, and storage equipment; set up a scheme for acquiring and maintaining food reserves, including infrastructure arrangements; and adopt cooperative measures for the production and marketing of agricultural inputs such as fertilizers, pesticides, and agricultural machinery and implements, as well as improved seed and livestock breeds.

Trade cooperation

While the scope of the Caracas program is very broad, it is in the area of trade that considerable attention has been focused. The section on trade is based on the premise that while trade among developing countries has expanded rapidly in recent years, there remains considerable room for growth, particularly if these countries are, by the year 2000, to account for at least 25 per cent of the world's industrial production as set forth at the United Nations Industrial Development Organization Conference held in Lima, Peru, in 1975. By 1978 only 26 per cent of the exports (excluding mineral fuels) of developing countries went to other developing countries, while only 14 per cent of their imports (also excluding mineral fuels) came from them.

To strengthen existing weak areas of marketing, distribution, and all levels of infrastructure needed for trade to expand, the program envisages cooperation arrangements among the state-trading organizations of the developing countries; the promotion of multinational marketing enterprises among them; the establishment of national enterprises in the fields of transportation, communications, shipping and insurance, and the conclusion of cooperation arrangements between these enterprises at the subregional, regional, and

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The more advanced developing countries would provide importers with assured supply, whether it should also encompass direct liberalization of trade should be limited to a interregional levels; and the fostering of technical cooperation among the developing countries through the establishment of multinational research and training institutions.

In addition to these institutional changes designed to promote intra-South trade, the Caracas program contains a specific agreement on the need to establish a system of trade preferences among developing countries. This is based on the premise that although trade among developing countries is likely to grow spontaneously (see the article on South-South trade by Havyrlyshyn and Wolf in the March 1982 issue of Finance & Development), a major reorientation in its geographical distribution cannot be expected without specific encouragement. Preferences would be a direct way of providing this encouragement.

Notwithstanding the substantial consensus among the developing countries on the desirability of trade preferences among developing countries, the implementation of a comprehensive program of preferences, it is now recognized, is a task fraught with difficulties. Some of these difficulties have already emerged during the preliminary discussions in 1980 and 1981 held by a United Nations Conference on Trade and Development-sponsored group of experts from developing countries on the establishment of the preference system.

A major issue is whether the liberalization of trade should be limited to a reduction of tariff and nontariff barriers or whether it should also encompass direct measures of trade promotion, such as long-term supply and purchase contracts that would provide importers with assured supplies and exporters with stable markets. The more advanced developing countries favor the first approach. By contrast, other developing countries, which rely significantly on state trading, insist on a long-term supply approach, arguing that because of their weak export structure and competitiveness they are unlikely to be able to take substantial advantage of the export opportunities arising from a mere reduction in tariff and nontariff barriers.

A second important and debated issue is whether tariffs should be reduced product by product or across the board. Most of its proponents favor an identical across-the-board tariff reduction for all customs items and all countries. Their argument is that, because of the emphasis of the Third World's industrialization policies on the development of consumer goods industries, protection is high for those goods which are the most susceptible to be traded among developing countries, and low or nonexistent for intermediate and capital goods for which the supply capability of these countries is very limited. An across-the-board reduction of tariffs among developing countries would not modify substantially the current situation for capital and intermediate goods but it could greatly foster intra-Third World trade in consumer goods for which it would provide a significant preference margin. This reasoning presupposes that a reduction would, in fact, increase trade. However, in some developing countries, tariff rates on consumer goods are so high that even after an across-the-board reduction they would remain prohibitive. Obviously some selection would have to be introduced, either through the stipulation of a maximum post-cut tariff level or through the adoption of a progressive formula that would call for greater cuts in the higher rates. Reaching agreement on any of these proposals, however, promises to be difficult.

Another delicate problem is how to maintain tariff preferences that developing countries have extended to each other in the framework of existing regional groupings. It is clear that if individual members of such groupings grant preferences to nonmember developing countries, the effect could erode the group system. To avoid such an erosion, the groupings would need to increase group preferences. This might well be difficult in view of the numerous obstacles that anyway exist to the strengthening of existing regional and subregional trade arrangements.

Although the experts of the Group of 77 have not yet been able to reach conclusions on these difficult issues, they did reach agreement at their meeting in November 1980 in Geneva on some broad guidelines for the initiation of negotiations on the global system. These guidelines stipulate, inter alia, that the system should be negotiated and established step by step; that the negotiations be reserved for the exclusive participation of the developing country members of the Group of 77; that the existing subregional, regional, and interregional groupings of such countries should participate fully in the negotiations; that the least developed countries should not be required to make concessions on a reciprocal basis; that the products covered by the system should include manufactures as well as commodities and agricultural products; and that, at the start of the negotiations, the participants should submit information concerning the areas in which they consider appropriate to offer concessions. Beyond these guidelines, it was agreed that a meeting of senior officials would be convened to consider the procedural and institutional arrangements needed for an effective launching of the negotiations.

Whatever those procedural decisions might be, it is clear that the establishment of the Global System of Trade Preferences will be a time-consuming exercise. In this connection, it may be recalled that the countries participating in the Tokyo Round of negotiations on the mutual reduction of tariff and nontariff trade barriers took some six years to reach agreement. Since commercial policies diverge more widely among developing than developed countries, it is likely that the negotiations on the global system will be complex and could require even more time than the Tokyo Round.

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**Related reading**


TRADE AMONG DEVELOPING COUNTRIES


Table 1
Trends in trade among developing countries (LDCs), 1960–79

<table>
<thead>
<tr>
<th>Year</th>
<th>All products</th>
<th>Intra-LDC trade</th>
<th>Excluding fuels</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960</td>
<td>6.10</td>
<td>6.10</td>
<td>3.83</td>
</tr>
<tr>
<td>1965</td>
<td>7.51</td>
<td>14.49</td>
<td>4.85</td>
</tr>
<tr>
<td>1970</td>
<td>11.17</td>
<td>15.47</td>
<td>7.34</td>
</tr>
<tr>
<td>1975</td>
<td>11.17</td>
<td>21.72</td>
<td>23.29</td>
</tr>
<tr>
<td>1979</td>
<td>103.07</td>
<td>22.30</td>
<td>54.43</td>
</tr>
</tbody>
</table>


Regional here refers to the United Nations division of developing countries into four regional groups: Latin America, Africa, West Asia, and South and Southeast Asia.

Table 2
Commodity structure of trade among developing countries, 1960–79

<table>
<thead>
<tr>
<th>Year</th>
<th>Food</th>
<th>Agricultural raw materials</th>
<th>Manufactures</th>
<th>Machinery and transport equipment</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960</td>
<td>43.2</td>
<td>22.9</td>
<td>26.9</td>
<td>3.6</td>
<td>105.0</td>
</tr>
<tr>
<td>1965</td>
<td>44.4</td>
<td>13.8</td>
<td>34.1</td>
<td>5.9</td>
<td>100.0</td>
</tr>
<tr>
<td>1970</td>
<td>31.3</td>
<td>16.4</td>
<td>42.6</td>
<td>8.9</td>
<td>100.0</td>
</tr>
<tr>
<td>1975</td>
<td>33.4</td>
<td>14.2</td>
<td>48.2</td>
<td>15.3</td>
<td>100.0</td>
</tr>
<tr>
<td>1979</td>
<td>39.0</td>
<td>16.4</td>
<td>51.6</td>
<td>17.5</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Per cent of total trade among developing countries

<table>
<thead>
<tr>
<th>Year</th>
<th>Food</th>
<th>Agricultural raw materials</th>
<th>Manufactures</th>
<th>Machinery and transport equipment</th>
<th>All other products</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960</td>
<td>45.5</td>
<td>22.9</td>
<td>26.9</td>
<td>3.6</td>
<td>7.0</td>
<td>100.0</td>
</tr>
<tr>
<td>1965</td>
<td>48.6</td>
<td>13.8</td>
<td>34.1</td>
<td>5.9</td>
<td>7.6</td>
<td>100.0</td>
</tr>
<tr>
<td>1970</td>
<td>40.1</td>
<td>16.4</td>
<td>42.6</td>
<td>8.9</td>
<td>9.7</td>
<td>100.0</td>
</tr>
<tr>
<td>1975</td>
<td>39.4</td>
<td>14.2</td>
<td>48.2</td>
<td>15.3</td>
<td>8.4</td>
<td>100.0</td>
</tr>
<tr>
<td>1979</td>
<td>34.2</td>
<td>16.4</td>
<td>51.6</td>
<td>17.5</td>
<td>9.4</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Per cent of total developing countries exports

<table>
<thead>
<tr>
<th>Year</th>
<th>Food</th>
<th>Agricultural raw materials</th>
<th>Manufactures</th>
<th>Machinery and transport equipment</th>
<th>All other products</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960</td>
<td>45.5</td>
<td>22.9</td>
<td>26.9</td>
<td>3.6</td>
<td>7.0</td>
<td>100.0</td>
</tr>
<tr>
<td>1965</td>
<td>48.6</td>
<td>13.8</td>
<td>34.1</td>
<td>5.9</td>
<td>7.6</td>
<td>100.0</td>
</tr>
<tr>
<td>1970</td>
<td>40.1</td>
<td>16.4</td>
<td>42.6</td>
<td>8.9</td>
<td>9.7</td>
<td>100.0</td>
</tr>
<tr>
<td>1975</td>
<td>39.4</td>
<td>14.2</td>
<td>48.2</td>
<td>15.3</td>
<td>8.4</td>
<td>100.0</td>
</tr>
<tr>
<td>1979</td>
<td>34.2</td>
<td>16.4</td>
<td>51.6</td>
<td>17.5</td>
<td>9.4</td>
<td>100.0</td>
</tr>
</tbody>
</table>


1Excluding fuels.

Table 3
Share of intra-LDC trade in total exports of developing countries, by major commodity groups, 1960–79

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Food</td>
<td>57.9</td>
<td>18.2</td>
<td>17.4</td>
<td>15.4</td>
<td>22.8</td>
</tr>
<tr>
<td>Agricultural raw materials</td>
<td>19.5</td>
<td>17.4</td>
<td>14.8</td>
<td>21.5</td>
<td>26.3</td>
</tr>
<tr>
<td>Manufactures</td>
<td>9.5</td>
<td>3.7</td>
<td>5.6</td>
<td>6.4</td>
<td>8.1</td>
</tr>
<tr>
<td>Fuels</td>
<td>235.7</td>
<td>23.7</td>
<td>23.6</td>
<td>21.1</td>
<td>20.8</td>
</tr>
<tr>
<td>Iron and steel</td>
<td>4.2</td>
<td>40.9</td>
<td>64.4</td>
<td>47.0</td>
<td>51.5</td>
</tr>
<tr>
<td>Nonferrous metals</td>
<td>8.2</td>
<td>6.0</td>
<td>6.2</td>
<td>6.3</td>
<td>17.0</td>
</tr>
<tr>
<td>Manufactured goods</td>
<td>79.3</td>
<td>42.7</td>
<td>38.0</td>
<td>34.5</td>
<td>36.3</td>
</tr>
<tr>
<td>All commodities</td>
<td>416.6</td>
<td>22.3</td>
<td>20.9</td>
<td>20.3</td>
<td>23.3</td>
</tr>
</tbody>
</table>


For reference only. Data refers to the value of trade among developing countries.

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Market factors in large industrial development projects

Large industrial projects in developing countries, whether publicly or privately owned, should be both economically and financially viable and subject to market discipline.

Chauncey F. Dewey and Harinder S. Kohli

Large industrial projects are an important element in the development programs of most developing countries. For many years, the Bank has helped finance such projects, whether government-owned or private, with a host-country guarantee. This article reviews some aspects of the Bank's experience with these projects.

The term "large" industrial project usually refers to new projects or expansions of existing projects whose investment requirements, including plant and related infrastructure, exceed US$100 million. Many of them are in heavy, capital-intensive basic industries such as steel and fertilizer production; others may be large projects in industries such as textiles or chemicals. Often
included in the category are smaller projects such as projects for cement mills, which may not be considered large in a developed country but are large in terms of the total investment budget of a developing country.

The benefits of large industrial projects are usually great. Such projects can lead to important improvements in the balance of payments, increased fiscal revenues, more inputs being available to local farmers and other producers, the generation of employment opportunities, the creation of industrial centers, and so on. For example, after achieving full production in the mid-1980s, the Jordan Arab Potash Project will generate about $200 million a year in net export earnings, about $100 million a year in additional government revenues, and also create about 800 new jobs—thus creating an important industrial growth center in a remote region of the country. (See box.)

Because large industrial projects are often seen as vital to a country’s growth and represent a large share of its budget, governments frequently take an active interest in them. The degree to which such projects are publicly or privately owned and managed is likely to be affected by their size in relation to the capabilities of the country’s private sector, by the country’s reluctance to allow what it sees as a strategically vital activity to be controlled by foreign businessmen, or by ideology. Often, however, the distinction between “public” and “private” is less than obvious. Some wholly government-owned parastatals (for example, PETROQUISA in Brazil)—and many with mixed ownership—are run like businesses and have substantial autonomy; some private businesses (such as Indian Explosives’ fertilizer operation) are so closely regulated that they have relatively little room for discretion. With or without ownership, governments can control enterprises and determine their profitability through regulatory policies, taxes, and their power to affect the prices of inputs and outputs.

Irrespective of ownership, experience indicates that the contribution to economic development of these large and highly visible undertakings is best assured if the signals of the market, adjusted as necessary to offset distortions, are followed at every stage of the project cycle. Such projects should be initiated only when there is a clear, sufficient, and continuing international or domestic demand for the product. And their design and subsequent operations should be such that they are financially viable—without protection or subsidy—as well as economically sound. For the World Bank, the technicalities of ownership are of less concern than the soundness of a project and the efficiency with which it is managed. Whether a large industrial project is public or private or has mixed ownership, sponsors and lenders should be guided, in their analysis, by relevant market factors and should emphasize the need, in the project’s operations, for private sector involvement through equity participation and through cofinancing (although where private ownership predominates, the Bank’s affiliate, the International Finance Corporation, has usually been the source of the loan). But cofinancing, of course, is not limited to private sources. Counting official sources, supplier credits, and private sources, the total cofinancing associated with the 31 Bank-financed large industrial projects that had some form of foreign cofinancing during 1977–81 amounted to about $2.8 billion, compared with Bank financing for these projects of $2.1 billion. Total financing for the projects exceeded $12.8 billion. (See Tables 1 and 2.)

Apart from financial involvement, private companies play an important role in the conception, management, and implementation of most large industrial projects. They are normally responsible for supplying the needed equipment and technology and the necessary design, engineering, procurement, erection, staff training, and project implementation services—usually, when Bank financing is involved, on the basis of international competition. The multifaceted relationship between large industrial projects and the private sector is expected to continue and become even more important in the future—as the capabilities of local business communities increase, international trade and financial flows grow, and developing country governments become increasingly aware of their limitations in the industrial sector.

**Efficiency, financial discipline**

Understanding the constraints facing large industrial projects and the interdependent, sometimes conflicting, factors that dictate success or failure is one thing:

---

**Table 1**

<table>
<thead>
<tr>
<th>Fiscal year</th>
<th>Total number of projects approved</th>
<th>Total financing required (in millions of U.S. dollars)</th>
<th>Bank/IDA loans</th>
<th>Foreign cofinancing</th>
<th>Projects with cofinancing</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>10</td>
<td>6,786.1</td>
<td>876.3</td>
<td>1,055.2</td>
<td>5</td>
</tr>
<tr>
<td>1980</td>
<td>10</td>
<td>1,497.5</td>
<td>514.5</td>
<td>538.9</td>
<td>6</td>
</tr>
<tr>
<td>1979</td>
<td>14</td>
<td>3,581.0</td>
<td>842.5</td>
<td>814.3</td>
<td>10</td>
</tr>
<tr>
<td>1978</td>
<td>8</td>
<td>1,659.0</td>
<td>391.8</td>
<td>201.2</td>
<td>4</td>
</tr>
<tr>
<td>1977</td>
<td>12</td>
<td>1,640.0</td>
<td>506.8</td>
<td>177.7</td>
<td>6</td>
</tr>
<tr>
<td>Total</td>
<td>54</td>
<td>15,163.9</td>
<td>3,131.9*</td>
<td>2,787.3</td>
<td>31</td>
</tr>
</tbody>
</table>

*Source: World Bank, Industrial Projects Department.*

1 Including projects without foreign cofinancing.
being able to achieve success in a particular social and political context is another. Success with large industrial projects requires the marriage of sound economic policies, good administration, and market forces. That this is well known has not, however, prevented costly, and sometimes grandiose, failures. For example, a fertilizer project in East Africa was abandoned after practically all the equipment was delivered and substantial site work completed, when the government realized the project was not economically viable and would require a substantial subsidy to run, which it could not afford to pay. Some failures of this sort have been caused by unanticipated national or international events, but many were simple failures of judgment that could have been prevented by rigorous evaluation and proper planning of the type recommended and practiced by the Bank.

### Pakistan Dawood Hercules

- **Project name**: Total project cost
- **Ownership**
- **Major lenders**
- **Product**
- **Main markets**
- **Main raw material**

<table>
<thead>
<tr>
<th>Project</th>
<th>Cost</th>
<th>Ownership</th>
<th>Multinational</th>
<th>Bank 51%</th>
<th>Arab Mining Company 25%</th>
<th>Islamic Development Bank 10%</th>
<th>Private owners and Arab states 18%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Urea fertilizer</td>
<td>US$84 million</td>
<td>Government of Jordan</td>
<td>51%</td>
<td>Arab Mining Company</td>
<td>Multinational 25%</td>
<td>Islamic Development Bank 10%</td>
<td>Private owners and Arab states 18%</td>
</tr>
<tr>
<td>Potash project in Jordan</td>
<td></td>
<td></td>
<td></td>
<td>Kuwait Fund</td>
<td>$15 million</td>
<td>Libyan Foreign Bank</td>
<td>$10 million</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>QDM (United Kingdom)</td>
<td>$20 million</td>
<td>Austrian Government</td>
<td>$30 million</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Commercial banks</td>
<td>$40 million</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Jordan Arab Potash

- **Project name**: Total project cost
- **Ownership**
- **Major lenders**
- **Product**
- **Main markets**
- **Main raw material**

<table>
<thead>
<tr>
<th>Project</th>
<th>Cost</th>
<th>Ownership</th>
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</tr>
</thead>
<tbody>
<tr>
<td>Potash project in Jordan</td>
<td></td>
<td></td>
<td></td>
<td>Kuwait Fund</td>
<td>$15 million</td>
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<td></td>
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<td></td>
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<td></td>
<td></td>
<td>Commercial banks</td>
<td>$40 million</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Ammonial/Urea project in Pakistan

One of the first major fertilizer projects financed by the Bank and the International Finance Corporation (IFC), this large complex supplies urea for the domestic market and utilizes natural gas, the preferred feedstock for nitrogen fertilizer production, available from a nearby gas field.

The local private owners provided an intimate knowledge of the local business environment, while the partner from the United States lent technical know-how of the fertilizer industry and was responsible for project management, staff training, and initial plant operations. The plant design was supplied by a reputed international chemical engineering firm and the plant was engineered and constructed by an experienced contractor. Both firms were based in the United States and well known to the technical partner. Most of the equipment and services were procured from private suppliers in the United States, the United Kingdom, France, Japan, and the Federal Republic of Germany.

The Bank and the IFC participated actively as an "honest broker" in the design, evaluation, and negotiations of the project concept and subsequent supervision of its implementation. The Government and the private partners looked to the Bank for help in ensuring that the division of benefits between the economy as a whole and the project as well as between the two major partners was appropriate, and that the regulatory environment would be such as to give the project sponsors the opportunity to earn a satisfactory profit. This was accomplished through a critical review of the joint venture agreements, implementation and procurement arrangements, and specific agreements on a financing plan and government fertilizer pricing policies.

The project was successfully completed in 1975 within schedule estimates and close to the original cost budget. The project provides Pakistan with urea at a production cost substantially lower than that of imported fertilizer. The project's economic rate of return calculated before the recent increases in international fertilizer prices was 18 per cent, compared to the 10 per cent estimated on the basis of assumptions used at the time of the approval of the project in 1968 by the Bank's Board. The project has been operating at or above nominal design capacity. The Project Performance Audit prepared after project completion by the Bank's independent Operations Evaluation Department found the project to be an economic, technical, and managerial success.

### Development

- **Development (USAID)**, the United Kingdom Overseas Development Ministry, the United Arab Emirates, and commercial (European, Jordanian) sources. The project was designed and engineered by a major U.S. engineering firm, which is also responsible for managing its implementation. The firm has signed a separate contract, with a provision for substantial profit sharing, to operate the project for the first five years, during which period local staff will gradually assume responsibility. The plant facilities are being built by contractors from the United Kingdom, Austria, the Federal Republic of Germany, the United States, and Korea. Equipment supplies are coming from all major developed countries. The company management is being assisted by technical advisors from the Netherlands, and management and financial consultants from the United Kingdom and the Philippines. This assistance from experienced foreign firms is helping the company to develop and operate on a sound commercial basis.

The project was inaugurated on March 18, 1982. It was completed within the original schedule and close to cost budget. The company has already signed long-term contracts for the sale of all its production to potash marketing companies in Europe, Japan, and the United States.

The Bank and USAID have played a major role in the design, preparation, appraisal, financing, and implementation of this project. As part of this assistance, the two institutions financed a $10 million engineering project in 1975 to develop the technology and design options for the project and recommend marketing, organizational, implementation, and financing arrangements. The Bank appraisal report was used by the non-Jordanian shareholders and other lenders as a basis for their financing decisions.
To ensure that projects use resources efficiently, both an economic and financial analysis are required. When designing a project, to ensure its economic efficiency it is essential to use "economic" prices for inputs and outputs—that is, prices which do not reflect subsidies or other distortions. At the same time, the project should be structured to permit financial viability during operations, based on the actual prices of inputs and outputs.

Prices, however, are often subject to nonmarket pressures. The products of projects in basic industries, for example, are frequently sold to politically vocal and important consumers who press for artificially low prices, such as farmers with respect to fertilizer and businessmen with respect to steel and cement. Similarly, project sponsors and management seek to ensure high output prices and protected, preferably noncompetitive, markets. If these pressures are allowed to distort the pricing of the project's inputs and outputs, financial discipline and management accountability will likely suffer and economic efficiency will decline as a result.

Ideally, domestic prices of inputs and outputs should be in line with long-term market prices. Similarly, the project ideally should be charged market rates for its financing. Otherwise, because of price distortions, the project's financial results may not reflect its economic costs, and inefficiencies may be hidden. A project (one, for example, to produce automobiles) may be profitable, due to subsidies, but be wasteful for the economy; or, more commonly, an economically beneficial project (to produce fertilizer, for example) may show losses—and have its financial accountability and management hampered—if output prices are held down by government regulation.

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**Harinder S. Kohli**

an Indian national, is Division Chief, Fertilizer, Refining and Other Chemical Industries Division, in the World Bank. He holds degrees from Punjab University (India) and Harvard University (U.S.A.). Mr. Kohli joined the Bank as a Young Professional in 1972. Before that he worked in private industry in India and France. Mr. Kohli has previously written on energy and industrial projects and is the author of a paper on "International Sources of Project Financing" (American Institute of Chemical Engineers, 1979).

In its continuing dialogues with country governments, the World Bank consistently favors the elimination of most direct and indirect subsidies to local industry—in order to restore to the market its valuable role as indicator/enforcer of economic efficiency. In its lending for large industrial projects—even under long-term International Development Association (IDA) credits, which carry minimal charges—the Bank requires the borrowing government to lend the proceeds to the beneficiary organization at or close to market interest rates and with a maturity period of 12 to 15 years.

Every World Bank loan agreement for an industrial project includes financial covenants to help ensure that the borrower will follow prudent financial policies, maintain a sound financial structure, and meet its financial obligations promptly. Such covenants commonly pertain, for example, to liquidity and debt service ratios, the financial rate of returns (where state government sets key prices), and debt/equity requirements. Projects, whether state or privately owned, should have sufficient initial equity in proportion to their debt to permit further financing on reasonable terms, as necessary, and to provide a cushion for debt service in times of adversity.

Having an economically efficient project—that is, one which produces a needed product at an appropriate quality level and at a true cost which is internationally competitive—requires, in addition to the usual financial analysis to establish the enterprise's amenability to efficient and accountable management, a careful analysis of all the significant economic costs and benefits. The cost of the investment should include the costs of new infrastructure needed for the project to operate efficiently. While appraising a proposal for a chemical plant, for example, one should review not only all factors influencing the viability of the plant itself but also the plant's impact on the need for related physical and social infrastructure in the country, such as housing, railway, port, road, power, water, warehousing, and distribution facilities. For the cost/benefit analysis, internal transfers in the economy that are not economic costs or benefits (such as duties and some taxes) should be disregarded, and appropriate adjustments in the prices of inputs and outputs should be made in order to eliminate distortions caused by market imperfections and local regulations controlling trade, currency, and prices. Based on such an analysis, the return on investment should be above the opportunity cost of capital—that is, above the returns from available alternative investments.
In performing an economic analysis, various alternatives are usually tested and "trade-offs" illuminated. There are likely to be trade-offs, for example, between, on the one hand, the duration and predictability of the time required to implement a large industrial project (which sometimes exceeds five years) and, on the other hand, the amount of capital and foreign expertise used. Balancing these elements requires substantial judgment, and local resources to develop indigenous know-how sometimes have to be taken into consideration together with economic factors including the cost of time and delay. Delays can be more expensive than commonly realized. Imported capital goods and equipment may lay idle and require storage. Implementation costs may increase more rapidly than the prices that can be charged for the project's output. Additional interest or management expense may be incurred. A need for additional foreign exchange may arise because the country must continue importing projects that will eventually be produced locally by the project or because the export earnings anticipated from the project are postponed. In addition, expensive delays can destroy the close communication, cooperation, and confidence among owners, consulting firms, and contractors that are usually essential to good project implementation.

After an evaluation of the economic costs and benefits of a proposed investment, it sometimes becomes evident that the project is not justified as conceived. This may result in its abandonment—as happened recently with a large steel complex and an aluminum project proposed to the Bank by two Middle Eastern countries. More frequently, it results in drastic changes in the scope, size, and timing of a project to make it economically attractive.

**Government involvement**

Large industrial projects often severely tax the limited financial and human resources of a developing country. Since many projects—those, for example, that exploit natural resources and are remote from their markets—have to be very large if they are to be economic, their capital costs can account for a substantial proportion of the development budget of a small- or medium-sized country. The potash fertilizer project in Jordan mentioned earlier required almost one third, and a paper pulp project in Tanzania absorbed approximately one quarter of these countries' total public investment budget for industry over a five-year period. The success or failure of projects of this size often has a significant impact on the country's balance of payments, its operating budget, the availability and prices of key products needed by other domestic undertakings, and the health of the industrial sector as a whole. Consequently, it is not hard to understand the reasons for government concern.

The degree of government involvement and ownership in such projects varies widely. Government involvement, depending partly on the proportion of government ownership, can range from the provision of fiscal and tax incentives and the supply of utility services and inputs of infrastructure facilities to the assurance of local markets for project output, the control of prices, and the provision of financing. Often—particularly in the case of projects in the mining and petroleum sector and projects providing basic industrial commodities such as steel, cement, and fertilizer—governments also become actively involved in corporate policies, especially those related to pricing, product distribution, procurement, management, and labor practices.

Governments with major financial participation often also exercise control over the nomination of key managers and staff salaries. In fully state-owned companies, which are often run as government departments, trusted civil servants, though inadequately trained to run a business, are sometimes nominated as key managers, and staff salaries are set low to correspond to civil service levels.

Strong government interest, with its likely concomitant political considerations and resulting lack of objective analysis, sometimes leads to poorly conceived and inefficient large industrial projects—some of which, if executed, become "white elephants." The Bank's experience with over 100 large industrial projects appraised during the past decade has confirmed that careful planning, good management, and substantial autonomy are normally the most important factors in making a project successful. Governments should allow even parastatal agencies maximum possible autonomy and they should judge the performance of their managers mainly on the basis of normal business and financial indicators. Before lending for large industrial projects, it is important, therefore, to assess the quality of management and the degree of autonomy that will be allowed.

In Egypt and Turkey, for example, where most parastatals have traditionally been inefficient large industrial projects, there is evidence that government officials and procedures are usually not well suited to managing large businesses effectively. Potential sponsors from the private sector, on the other hand, because of their limited financial and human resources and their perceptions of higher business risks in the large industrial projects in developing countries, are often unable or unwilling to promote and finance them without active government participation. The challenge is how to mesh effectively the provision of needed resources controlled by the government with the discipline of the market and the capabilities and knowledge of the private sector within and outside the country.

In the case of two Bank-assisted fertilizer projects, the box on page 27 illustrates many aspects of the multifaceted interrelationship between the public and private sector. Not detailed in the box, but as important as ownership, is the careful application of disciplined economic and financial analysis to large industrial projects and the effort to increase the influence on them of market forces.

That approach not only fosters sound investments but also helps the Bank earn the cooperation and trust of cofinanciers—as does its emphasis on managerial competence and autonomy, comprehensive agreements with governments and borrowers, and close monitoring during project implementation. Irrespective of ownership, it is important to bring to bear every means available to ensure the financial viability, the economic efficiency, and the technical soundness of these complex and important projects.
**World Bank cofinancing with the private sector**

The Bank’s cofinancing program aims to encourage private financial institutions to direct their lending in developing countries to high priority projects in different sectors, to introduce new lenders to developing countries, to bring new entities in borrowing countries to the market, and, more generally, to encourage the Bank’s borrowers to broaden their sources of external finance and diversify the instruments of borrowing.

Through cofinancing, the World Bank’s role as a catalyst in attracting development finance for high priority programs within developing countries has increased significantly in recent years. Between fiscal years 1977 and 1981, cofinancing reached a yearly average of nearly $3.7 billion in around 90 projects per year. It has been a feature in about 37 per cent of Bank/IDA operations, and the volume of funds mobilized from other sources external to borrowing countries has been equivalent to more than 36 per cent of the total volume of World Bank lending. Historically, the major source of cofinancing has been official bilateral and multilateral aid agencies. However, in fiscal year 1981, cofinancing with commercial banks became the single most important source for the first time, contributing about $1.7 billion to project financing in approximately 18 operations.

The Bank is placing increased emphasis on cofinancing with private financial institutions and is taking a number of measures to expand its association with private lenders, including a more active promotional program vis-à-vis the private banking community and new techniques of cofinancing that could make it more attractive to some borrowers and private lenders.

---

**World Bank cofinancing operations by region, fiscal year 1981**

(In millions of U.S. dollars)

<table>
<thead>
<tr>
<th>Region</th>
<th>Projects with cofinancing</th>
<th>Source of cofinancing</th>
<th>Bank contribution</th>
<th>Total project costs</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number</td>
<td>Amount</td>
<td>Official</td>
<td>Number</td>
</tr>
<tr>
<td>Eastern Africa</td>
<td>15</td>
<td>179.8</td>
<td>15</td>
<td>179.8</td>
</tr>
<tr>
<td>Western Africa</td>
<td>12</td>
<td>178.8</td>
<td>12</td>
<td>178.8</td>
</tr>
<tr>
<td>Europe, Middle East and North Africa</td>
<td>18</td>
<td>510.9</td>
<td>10</td>
<td>102.9</td>
</tr>
<tr>
<td>Latin America and the Caribbean</td>
<td>13</td>
<td>1,530.3</td>
<td>10</td>
<td>275.3</td>
</tr>
<tr>
<td>East Asia and Pacific</td>
<td>9</td>
<td>1,027.7</td>
<td>7</td>
<td>412.4</td>
</tr>
<tr>
<td>South Asia</td>
<td>12</td>
<td>610.5</td>
<td>12</td>
<td>420.5</td>
</tr>
<tr>
<td>Total</td>
<td>79</td>
<td>4,038.0</td>
<td>66</td>
<td>1,569.7</td>
</tr>
</tbody>
</table>

Source: Information extracted from President’s Reports and Appraisal Reports. World Bank

1 Ending June 30, 1981
2 The number of individual operations with cofinancing by source is greater than the total number of projects with cofinancing since there are projects cofinanced with more than one source

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The private sector as "principal"

Political commitment, supportive policies, and a legacy of economic modernization have enabled the private sector to play a critical role in Korea's economic growth.

Larry E. Westphal

Between 1963 and 1978 the Republic of Korea (often referred to as South Korea, and here as Korea) was one of the most dynamic and successful developing economies. Yet in the late 1950s many observers feared that it was a "basket case" incapable of self-sustained development. Why were Korea's prospects then rated to be so unpromising? Why did Korea begin its remarkable economic takeoff in 1963?

The answer lies in the political changes that in the early 1960s brought to power a leadership strongly committed to economic development and able to formulate and implement effective policies to promote export-led industrialization and to increase domestic saving. But those policies—and their implementation—do not stand alone. They were superimposed on a legacy of social, political, and economic structures which were favorable to economic development. One expression of this legacy can be found in the flexible and pragmatic relationship between business and government. Korea's rapid economic growth since the early 1960s "has been a government-directed development in which the principal engine has been private enterprise" (Mason, et al., 1980, p. 254). While not all aspects of the Korean experience could or should be replicated elsewhere, it does provide some broad lessons, many of which could be relevant to the economic management of other developing countries.

Chung Hee Park assumed control of the Government after a military coup in 1961, was elected president of the newly constituted civilian government in 1963, and was re-elected several times to remain president...
engine" of development: Korea

until his assassination in 1979. From the beginning, the overriding objective of Park's rule was economic growth. Typical of Park's thinking is the following statement, made in 1962: "In human life, economics precedes politics or culture." Another statement, in 1963, suggests the reasoning behind the primacy of the growth objective: "Economic resurgence is an integral part of a nationalistic vision of a more independent Korea to come—more independent of the United States aid and control and, as an economically stronger and independent entity, more able to deal with North Korea" (both quotations from Mason, et al., 1980, p. 251 and p. 46). Park was not alone in holding these views, and the rapid economic growth achieved under his leadership established the legitimacy of his government. Although there was a recognition of the desirability of changing Korea's development strategy before Park came to power—for example, the first major reform was introduced in 1961, when a complex multiple-rate system was replaced by a unitary exchange rate—Park's sustained commitment was central to the ultimate success of the process of reform.

The economic policy reforms in the 1960s had two principal objectives. The one that dominated policymakers' efforts was to shift from an inward-looking strategy to one of export-led industrialization. The other concerned efforts to increase public and private saving. The specific details of the several reform programs had more than once to be adjusted in major respects as circumstances changed. For example, the unitary exchange rate was abandoned in 1963, when a reduction in aid caused a balance of payments crisis, and was then reintroduced a year later. Moreover, the reforms were spread over many years. The last major reform—a liberalization of import controls—came in 1967.

Implementing the shift in development strategy required many policy changes. The official exchange rate of the won was increased from 62.5 won to the dollar in 1960 to 265.4 in 1964 and was thereafter generally maintained at levels that realistically reflected economic costs. A free trade regime was created for exporters, who were given unrestricted access to imported inputs as well as exemptions from tariffs and indirect taxes, and were also granted reduced charges on overheads together with credit and direct tax preferences.

Changes in the foreign exchange regime relating to imports greatly reduced the incentives for socially unprofitable import substitution. More generally, the reforms brought the financial profitability of different activities more nearly in line with their true economic profitability. The administration of government revenue collection was overhauled to achieve a much higher ratio of revenue to gross national product (GNP), and determined measures were taken to hold down government expenditure. In addition, the pricing policies of public enterprises were changed to achieve full cost recovery, so that these enterprises became net contributors to the government budget. To stimulate private saving, the interest rate was raised in real terms to about 10 per cent a year by means of higher bank interest rates and the introduction of a price stabilization program.

Korea's rapid economic growth dates from 1963, the middle of the period of policy reform. But the acceleration of growth was not abrupt; the transition lasted roughly three years. Selected indicators showing the results of Korea's shift to a strategy of export-led industrialization are given in the table. Domestic savings in relation to GNP in current prices rose from 3 per cent in 1960-62 to 18.7 per cent in 1974-76, with increased government saving responsible for slightly more than half the change. Total employment increased 3.9 per cent a year from 1963 to 1976; while manufacturing employment rose 12.1 per cent (comparable figures are not available for earlier years).

The historical legacy

In addition to the policy reforms associated with the shift to an export-led strategy, the principal keys to understanding Korea's remarkable performance since the early 1960s are to be found in its history before the economic takeoff and the character of the Government's intervention.

Korea's precolonial heritage includes social, political, and economic structures that had already experienced significant development along modern lines. For nearly a thousand years before their separation at the end of World War II, North and South Korea constituted an autonomous ethnic, cultural, linguistic, and political entity. Traditional Korea was not "opened up" to the West until 1876, after which it gradually fell under the dominance of Japan, finally becoming a Japanese colony in 1910. The homogeneity and historical unity of the populace distinguish Korea from many other developing countries. So too does the peninsula's colonial experience. Japanese colonialism was harsh in social and political terms; in economic terms, there is evidence that at least half of the Korean populace suffered a fall in real incomes during the colonial period. Nonetheless, Japanese colonialism appears to have left a richer legacy of human capital and institutional forms than was typical of Western colonialism. It also is true that Korea's economy in the nineteenth century was relatively well developed. The process of modernization in the precolonial period centered on agriculture and commerce.
By the nineteenth century, Korea had developed a complex and relatively advanced agricultural technology, together with a land tenure system that, though based on landlordism, had a number of “modern” characteristics and a rural labor force that had gradually been freed from slavery and serfdom. The commercial sector and urban centers in traditional Korea were also far more developed than those of many present-day developing countries in the nineteenth century. Confucianism was an important part of its heritage; the emphasis on education permeated all traditional institutions. An excellent phonetic alphabet—Han'gul, invented in the fifteenth century—appears to have been used extensively in commerce, and most of the male population could probably read some Han'gul, if not write it.

Korea’s economic transformation as we know it today began during the colonial period (1910-45), when the peninsula’s economy was managed as an integral part of the Japanese Empire. Led by a dynamic export sector, the economy grew at what, for that time, was a rapid pace: it is estimated that from 1910-12 to 1939-41 real value added in manufacturing grew more than 10 per cent a year. And by 1936-40 manufactured goods accounted for more than 40 per cent of exports, which in turn accounted for well over a quarter of commodity production.

This economic development was heavily dependent on Japanese residents in Korea. In industry they contributed more than 90 per cent of the capital and were disproportionately represented in the labor force, particularly among engineers and technicians. In agriculture the Japanese established an effective extension service, which introduced the use of chemical fertilizers and high-yielding plant varieties. They also instituted modern fiscal and monetary systems. Power generation facilities were built (most in what was to become North Korea), as were a north-south railway and other infrastructure. In addition, the educational system was greatly expanded by the Japanese, particularly at the primary level, but also at the secondary and college levels.

Human capital formation is the most important legacy of the colonial period. But formal education was less important than the learning-by-doing in modern economic activities and the demonstration effect of development under the Japanese.

**Growth checked**

Korea’s historical heritage, all too often neglected in analyses of Korean development, comprised many elements conducive to self-sustained development. But circumstances constrained the realization of the benefits of that legacy. Economic activity collapsed in 1945, in the aftermath of the withdrawal of Japanese, the loss of external markets occasioned by the dissolution of the Japanese Empire, and the economic dislocation and political instability that accompanied the peninsula’s division. Korea became independent in 1948, when U.S. military rule ended. But the Korean war (1950-53) again devastated the South’s economy: in all sectors, output in 1953 was substantially below what it had been in 1939-40.

Many creations of the colonial period did not survive the departure of the Japanese at the war’s end. The fiscal and financial systems suffered severe retrogression and did not attain colonial levels of development until the late 1960s. The agricultural extension structure almost disappeared and was only slowly reconstructed, starting in the second half of the 1950s. In manufacturing and construction, the number of operating establishments in South Korea fell from 10,000 in 1943 to 4,500 in 1947-48; manufacturing output in the latter years was only 15 per cent of what it had been in 1939.

But it is significant, particularly in light of circumstances at the time, that the South Koreans were able, just after the war and with relatively little foreign managerial or technical assistance, to operate nearly half the manufacturing plants that existed in 1944—producing such goods as shoes, textiles, rubber tires, and a wide variety of engineering products. Nevertheless, Korea’s economic performance during the 1950s and early 1960s was poor—despite the fact that foreign assistance financed more than 60 per cent of total imports and 80 per cent of investment. Although real value added in manufacturing increased at a respectable rate, there were clear signs of rapidly diminishing returns to the import substitution on which this growth was based. Government policies, which subordinated economic growth to reconstruction and price stabilization, were largely to blame for the poor performance.

**Government-business relations**

A major element in initiating and sustaining Korea’s export-led development was the relationship between government and business—characterized by close cooperation and selective government interventions across a wide range of activities, interventions that go beyond the creation of market (nondiscretionary) incentives. Nonetheless, Korea’s successful export performance derived and still derives primarily from initiatives taken by firms acting within a decentralized system and in response to generalized incentives as well as strong government prodding.

The balance between selective interventions and market incentives is subtle and hard both to define and to describe briefly. It is perhaps best illustrated by the Government’s export promotion program. The Government has relied on market incentive policies to ensure that firms earn adequate profits on their exports. These incentives are applied across the board and generally operate through taxes and measures that affect market prices; they apply to all firms automatically. An example would be automatic exemption from tariffs for imported inputs used in export production.
The Government has also used other, less automatic instruments that apply only to selected firms, industries, or goods. Among selective interventions used are publicly announced quarterly export targets for individual commodities, markets, and domestic exporters. Contact between government and business in the day-to-day implementation of these targets is close. Next to the responsible minister's office is an "export situation room," laid out so that potential target shortfalls can be identified at a glance. A large staff maintains almost daily contact with major exporters, and it is not uncommon for the minister to intercede in difficult situations. The progress toward targets and the current trade situation are regularly reviewed at the Monthly Trade Promotion Conference, chaired by the President and attended by ministers, bankers, and the more successful exporters; the highest export achievements bring national awards as well as material benefits, including relaxed tax surveillance.

It would be inaccurate to conclude that the Government independently sets targets to determine export levels. The targets are indicative and are negotiated jointly by the Government and the exporters' associations, sometimes in combination with export subsidies to secure acceptance of the targets. Moreover, the targets have generally been met or exceeded, even when revised upwards during the year. The target system has thus served to keep the Government well informed about export performance so that timely changes could be made in incentives, often including ad hoc assistance to individual exporters.

But the system has also stimulated exports—particularly by newly emerging export sectors, which typically operate as cartels and which, through protection, receive higher incentives to sell domestically than to export. The Government appears to have encouraged the formation of cartels in these industries to promote "infant industry" exports. By using the export target system, the Government could make sure that these industries exported part of their output. The use of targets together with associated selective interventions has thus enabled the Government to link selling in the profitable domestic market to satisfactory export performance. Also important in giving the Government leverage over these industries has been the granting of selective credit incentives through its absolute control over bank credit allocations and access to foreign borrowing.

However, by no means are all new entries into export markets the result of selective intervention by the Government. Indeed, exports from selectively promoted infant industries have never accounted for more than a quarter of Korea's manufactured exports. For most exports, targets have worked together with the market incentives to promote rapid expansion.

The target system and its trappings have publicized the tremendous importance the Government has attached to exports, and have thus helped to create an atmosphere in which business could be certain that export activity would be rewarded. But it is businessmen, largely private, who have responded by taking the substantial risks of expanding production and capacity for export.

Even though outward-looking, the Government's strategy has not been one of purely free trade. The Government has selectively promoted import substitution in such nontraditional sectors as producer goods (petrochemicals and electrical machinery, for example) and, of late, consumer durables and automobiles. The most important instruments of promotion have been protection as well as preferential access to credit on preferential terms and the authority to borrow abroad. But in several instances where private interests have been reluctant, public enterprises have been used to initiate import substitution. Korea's integrated steel mill is a case in point. Among the most efficient in the world, it has penetrated the markets of the developed countries. More generally, the Government has used public enterprises where this best suits its objectives. The share of public enterprises in nonagricultural GDP is comparatively high, being similar to that in India.

The Government has intervened less in other parts of the economy, relying instead on the dynamism of Korean private enterprise. Until the late 1960s and early 1970s, the Government's approach to the development of agriculture and the social overhead sectors was one of benign neglect. But nonetheless these sectors developed rapidly, largely because of private initiatives in response to market forces. Farmers turned increasingly to the production of noncereal crops to meet newly emerging urban demands. Private firms came forth to provide urban mass transit. Numerous medical facilities were established to provide health care. Private schools sprang up at all levels to satisfy the almost insatiable demand for education. In short, the development of the nonindustrial sectors has followed and been pulled by the development of industry, which would not have been feasible without a highly dynamic and responsive private sector.

The result has not only been rapid growth; in addition, the benefits of development have been spread relatively evenly across the population. This can be traced to the employment intensity of Korea's export-led development and to events early in Korea's history as an independent nation. A far-reaching land reform program—which was initiated by the U.S. military authorities in 1948 and completed by the newly independent Korean government in 1949—together with the economic dislocation caused by war and the departure of the Japanese, produced in Korea a relatively egalitarian distribution of assets, which subsequent development has not greatly changed.

**Lessons**

The experience of Korea is of obvious interest to policymakers in developing countries. It is widely appreciated that the adoption of an export-led strategy of industrial development was responsible for the transformation of Korea's economy. But it is a popular misconception to ascribe Korea's success to its special relationships with the United States and Japan, which are supposed to have resulted in massive aid flows and trade preferences, without which the Korean economy would not have grown so rapidly. Korea did benefit from massive aid flows, but this was before its economic takeoff. Since then most capital inflows have been private and in the form of credit rather than equity. Moreover, there is no evidence that Korea has received special trade preferences from any country. It would also be wrong to ascribe Korea's success to its having copied the Japanese model. Japan's experience demonstrated the advantage of export-led industrial development, but the Korean government has by no means slavishly copied Japanese policies or institutional forms. Korea did follow the Japanese in establishing large trading firms for foreign marketing. But to cite one major difference, public ownership of the banking system has given the Korean...
"...the effectiveness of the Government’s direction of economic activity can also be ascribed to the leadership’s single-minded commitment to economic growth and, at a deeper level, to its identification of rapid growth with export-led development."
The varying experience of seven Asian countries facing similar rates of imported inflation shows the importance of coordinating monetary and exchange rate policies in these countries.

Bijan B. Aghevli

A study of the exchange rate policies of seven Asian countries (India, Indonesia, Korea, Malaysia, the Philippines, Singapore, and Thailand) in 1973-78 reveals that countries with higher rates of inflation pegged their currency to the U.S. dollar and those with lower inflation rates adopted a managed float. Since all seven countries faced similar rates of foreign inflation, the differences in their domestic inflation rates were mainly attributable to the differences in their monetary policies. The differences between domestic and foreign inflation in these countries were partially offset by the movements of their effective exchange rates. However, these countries were generally reluctant to undertake large adjustments in their exchange rates, even when there were substantial differences between domestic and foreign rates of inflation. Consequently, the real exchange rate (defined as the relative price of imported and domestic goods) of the high inflation countries appreciated while that of the low inflation countries depreciated.

The deterioration of the relative price of tradable goods in the high inflation countries resulted in a shift in aggregate demand in favor of tradable goods and in a

This article is based on a study by the author published in Exchange Rate Rules: The Theory, Performance, and Prospects of the Crawling Peg, edited by John Williamson (New York, St. Martin’s Press, 1981).
shift in aggregate supply in the opposite direction, as domestic resources were channeled into the relatively more profitable nontraded sector. The consequent excess demand for tradable goods was reflected in a deterioration of the external position in the high inflation countries. Analogously, the improvement in the relative price of tradable goods in the low inflation countries resulted in a strengthening of their external positions.

**Regimes**

Prior to the breakdown of the Bretton Woods system in August 1971, most Asian countries pegged their exchange rates to the effective depreciation, however, was not enough to offset the difference between domestic and foreign inflation for high inflation countries.

**Trends**

The exchange rate had its major impact on the economy in the Asian countries through its effect on relative prices and resource allocation. In the industrial countries, exchange rate variability has often been viewed as a major source of instability in the money and capital markets. Consequently, there is a great interest in these countries on expectations about future spot exchange rates and on interest rate differentials. In the Asian countries, however, their intervention currencies with prescribed margins. Indonesia and Thailand were pegged to the U.S. dollar; India, Malaysia, and Singapore were pegged to the pound sterling; and only Korea and the Philippines were floating. A description of the exchange rate regimes of the Asian countries since the generalized floating of major currencies is provided in Table 1. This description is based on "revealed" as opposed to "officially announced" policies. Thus, all those countries that pegged to an undisclosed basket are put into the category of managed float, except those cases when the fluctuations of the exchange rate, in terms of the U.S. dollar, remained within a margin of 2.25 per cent; those cases are classified as pegging to the dollar.

A comparison of the exchange rate regimes and average inflation rates for various countries reveals an interesting pattern. Countries with higher rates of inflation pegged their currency to the U.S. dollar and those with lower inflation rates adopted a managed float. Consequently, the effective exchange rates of those countries with higher rates of inflation depreciated along with the U.S. dollar (the effective rate is defined as the weighted average of the bilateral exchange rates). This effective depreciation, however, was not private capital movements are influenced more by political factors than by exchange rate variability and interest rate differentials. Moreover, because of the fragmentation of financial markets, the size of private capital flows is relatively small and the movements are dominated by official transactions.

The exchange rate is generally regarded as affecting resource allocation through its impact on three sectors: the export, import-competing, and nontraded sectors. In the Asian countries being considered, prices for most import and export commodities are given and are, therefore, not affected by the exchange rate. So, the export and import-competing industries can be considered as a single sector that can be identified as the "traded sector." The domestic price of traded goods is then determined by their price on world markets converted into home currency at the given exchange rate. In these countries, therefore, the exchange rate affects resource allocation via its impact on the relative prices of traded and nontraded goods.

The estimated trend and the index of variability for domestic prices, foreign prices, effective exchange rates, and the real exchange rate are given in Table 2 for the two periods corresponding to the pegged regime (1968-72) and to the flexible regime (1973-78). Based on this information, two types of comparisons are possible. First, interperiod comparisons can be made in order to discern significant changes in the pattern of variations in prices and exchange rates under the two regimes. Second, intercountry comparisons can be made to identify general patterns in the exchange rate policies of the Asian countries.

An examination of price movements in the two periods reveals that in each country both the level and the variability of domestic inflation were higher during the second period, providing apparent support for the conjecture that higher rates of inflation are associated with higher variability of inflation. This association, however, does not strictly hold across countries; the variability of inflation is not necessarily higher for higher inflation countries. Neither does there appear to be a relationship, interperiod or intercountry, between inflation rates and growth rates in gross national product (GNP).

The foreign rates of inflation affecting each of the Asian countries were very close to each other because the bulk of these countries' trade was with the same industrial countries. The average foreign inflation was around 3 per cent in the first period and about 7 per cent in the second period. The fact that both domestic and foreign inflation rates for all countries were higher during the second period, relative to the first, is consistent with the argument that imported inflation contributed to domestic inflation in the Asian countries. However, the diversity of inflation rates among the Asian countries indicates that inflation also responded to other factors.

The effective exchange rate of each of the Asian countries depreciated over both periods (with the exception of Singapore whose rate appreciated slightly). In all cases the depreciation was higher during the first period when, although exchange

**Table 1**

<table>
<thead>
<tr>
<th>Exchange rate regime</th>
<th>Inflation rate (in per cent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>U.S. dollar peg 1971–78</td>
</tr>
<tr>
<td>Korea</td>
<td>Managed float 1971–73; U.S. dollar peg 1974–78</td>
</tr>
<tr>
<td>Philippines</td>
<td>Managed float 1971–74; U.S. dollar peg 1975–78</td>
</tr>
<tr>
<td>Thailand</td>
<td>U.S. dollar peg 1971–78</td>
</tr>
<tr>
<td>Malaysia</td>
<td>Sterling peg 1971–72; managed float 1973–78</td>
</tr>
<tr>
<td>India</td>
<td>Sterling peg 1971–74; managed float 1975–78</td>
</tr>
<tr>
<td>Singapore</td>
<td>Sterling peg 1971–72; managed float 1973–78</td>
</tr>
</tbody>
</table>

1. Average annual inflation rate of the consumer price index between 1973 and 1978.
rates were adjusted less frequently, the adjustments themselves were larger. This somewhat paradoxical result is particularly true for the higher inflation countries. During the first period their inflation rates were lower, yet the effective exchange rates were less stable; during the second period, however, their effective exchange rates depreciated with the U.S. dollar, but relatively little, because they were reluctant to devalue. The variability of effective exchange rates was in general higher during the second period.

The changes in the real exchange rate reflect the net effect of the changes in domestic prices, foreign prices, and effective exchange rates. During the first period real exchange rates depreciated in all cases, as the higher inflation countries devalued by more than the difference between their domestic and foreign inflation, and low inflation countries maintained a stable exchange rate. During the second period the changes in real exchange rates were dominated by relative price movements. Therefore, the real exchange rates of high inflation countries (Indonesia and Korea) appreciated; those of medium inflation countries (the Philippines and Thailand) remained relatively stable; and those of low inflation countries (India, Malaysia, and Singapore) depreciated.

Inflation and BOP determinants

Three types of factors can be identified as causing domestic inflation in open economies: structural, external, and monetary. Structural factors, such as the wage and price rigidities that are often a source of inflationary pressure in the industrial countries, are relatively unimportant in the Asian countries; because of the existence of surplus labor, the size and power of organized labor tends to be limited. Thus, for all practical purposes external and monetary factors are the main determinants of domestic inflation in these countries.

Domestic inflation is affected by imported inflation, directly through the price of traded goods and indirectly through the price of nontraded goods. The latter effect operates with a lag because as traded prices increase, supply tends to shift from nontraded to traded goods, while demand shifts from traded to nontraded goods; the consequent excess demand for nontraded goods causes their price to increase. Taking account also of the influence of domestic monetary expansion on inflation, the rate of change of domestic prices can be specified as a function of the rate of change of traded goods prices and the rate of change of money supply.

In addition to increasing demand for nontraded goods, an excess supply of money increases demand for traded goods and results in a deterioration of the balance of payments (BOP). This relationship is the focus of the monetary approach to BOP, which views the BOP as the main endogenous channel through which the excess supply of money is eliminated in an open economy. In some of the earlier literature in this area, domestic prices were regarded as exogenously determined for small countries, and monetary factors only affected the BOP. However, with the inclusion of nontraded goods into the analysis, part of the excess supply of money is spent on them, pushing domestic prices up, thereby changing the real exchange rate. The changes in the real exchange rate, in turn, affect the excess demand for traded goods and consequently the BOP position.

In order to examine the validity of these relationships for domestic inflation and the BOP, a causality test was devised, based on an extension of the direct method suggested first by Pierce and Haugh (1977). The results indicate that domestic inflation in each country was caused both by imported inflation and by monetary expansion, and that the BOP outcome was caused by domestic credit expansion and by the changes in the real exchange rate. Moreover, in all cases except India, the rate of monetary expansion contributed more than the imported inflation to domestic inflation. Similarly, in all cases except India, the changes in domestic credit were the primary factor contributing to the BOP result.

Role of exchange rate policies

Insofar as each of the Asian countries experienced a similar rate of foreign inflation and relatively small movements in their effective exchange rates, the diversity of their inflation rates could be attributed largely to differences in their monetary policy; in fact, an ordinal ranking of countries according to their rates of monetary expansion matches that according to their rates of domestic inflation (Table 3). In the case of low inflation countries, imported inflation was a significant factor contributing to domestic price movements. In the case of higher inflation countries, rapid rates of domestic monetary expansion were the major contributing factor.

The exchange rate policies of the Asian countries resulted in movements in their effective exchange rates that partially offset the differences between domestic and foreign inflation rates. Those countries with inflation rates higher than their trading partners (Indonesia, Korea, the Philippines, and Thailand) effectively pegged

| Table 2 |
| Trend and variability of output, prices, and exchange rates, 1968–78 (Average annual rates of change, in per cent) |
| Output<sup>1</sup> | Domestic prices | Foreign prices | Effective exchange rate<sup>2</sup> | Real exchange rate<sup>2</sup> |
| Trend | Trend | Variability | Trend | Variability | Trend | Variability |
| Indonesia | 1968–72 | 8.3 | 8.9 | 5.7 | 3.1 | 1.4 | -10.7 | 4.1 | -4.9 | 6.8 |
| 1973–78 | 7.7 | 17.1 | 7.9 | 6.7 | 8.0 | -2.8 | 8.8 | 7.6 | 10.5 |
| Korea | 1968–72 | 10.0 | 11.5 | 1.8 | 2.9 | 1.8 | -11.1 | 5.3 | -2.4 | 4.3 |
| 1973–78 | 11.1 | 16.1 | 5.0 | 6.6 | 8.6 | -6.2 | 5.0 | 3.3 | 6.7 |
| Philippines | 1968–72 | 4.1 | 10.5 | 3.5 | 3.2 | 1.4 | -17.4 | 10.6 | -10.1 | 10.5 |
| 1973–78 | 6.6 | 10.5 | 7.2 | 7.2 | 7.8 | -3.6 | 3.4 | -0.3 | 3.2 |
| Thailand | 1968–72 | 7.1 | 1.6 | 1.6 | 3.4 | 1.5 | -2.7 | 2.4 | -4.4 | 1.5 |
| 1973–78 | 7.9 | 8.2 | 4.7 | 6.8 | 7.9 | -1.8 | 6.3 | -0.4 | 3.5 |
| Malaysia | 1968–72 | 6.2 | 1.6 | 1.2 | 3.4 | 1.2 | -0.1 | 0.8 | -1.9 | 1.9 |
| 1973–78 | 7.8 | 5.8 | 3.9 | 7.8 | 7.1 | 0.0 | 3.6 | -2.2 | 2.8 |
| India | 1968–72 | 3.6 | 3.9 | 2.3 | 3.6 | 1.1 | -2.2 | 2.5 | -2.1 | 1.9 |
| 1973–78 | 3.4 | 5.3 | 8.5 | 9.1 | 6.3 | -1.9 | 2.2 | -5.7 | 5.3 |
| Singapore | 1968–72 | 13.4 | 1.2 | 1.5 | 2.0 | 2.2 | 0.3 | 0.7 | -0.6 | 3.4 |
| 1973–78 | 7.7 | 4.5 | 6.3 | 7.9 | 7.1 | 0.0 | 2.6 | -3.4 | 3.9 |

Sources: IMF, International Financial Statistics and Fund staff.

1A measure of variability is not provided for output because these series are available only on annual basis.

2The weighted average of the bilateral exchange rates.

3The relative price of imports to domestic goods.
their currencies to the U.S. dollar, allowing them to depreciate along with the dollar. Countries with inflation rates lower than their trading partners (India, Malaysia, and Singapore) floated their currencies, allowing them to appreciate against the dollar. In general, however, the movements of effective exchange rates in the various countries were relatively small, reflecting the reluctance of the countries to undertake large adjustments, even when domestic inflation rates were substantially different from foreign inflation rates.

This reluctance could partly be attributed to the political implications of an exchange rate adjustment, particularly when domestic inflation was high and fears existed that a devaluation would exacerbate inflationary pressures. Also, because of the uncertainties associated with fluctuations in bilateral exchange rates among the major currencies, a number of countries adopted a wait-and-see attitude. Moreover, the depreciation of the U.S. dollar partially

depreciation of the real exchange rate is proportional to the differences in their rates of domestic and foreign inflation, and to the length of the lag with which the exchange rate is adjusted. The relative strength in the external positions of the various countries was generally consistent with the movements of their real exchange rates during the sample period; the reserve-import ratios of the countries closely paralleled the degree of appreciation of their real exchange rates.

Coordination important

On the basis of the observed regularities between domestic inflation rates and the movements of the real exchange rates, some generalizations about the exchange rate and monetary policies of the seven Asian countries can be made. The medium inflation countries (the Philippines and Thailand), with inflation rates somewhat larger than those of their trading partners, maintained relative stability in their real exchange rates. The relatively small adjustments of the currencies, a number of countries adopted a wait-and-see attitude. Moreover, the depreciation of the U.S. dollar partially

masked the need for further adjustment of those currencies that were pegged to the dollar.

The relatively small adjustments of the effective exchange rates resulted in a striking pattern: an ordinal ranking of the Asian countries according to the difference between their domestic and foreign inflation identically matches their ranking according to the amount of appreciation of their real exchange rates. The reluctance of the authorities to undertake large adjustments in the exchange rate tended to lead to an overvaluation of the currency in high inflation countries and to an undervaluation in low inflation countries. (It should be noted that the movements of real exchange rates do not necessarily imply an overvaluation or undervaluation of the currency, because the equilibrium level of relative prices of the traded and nontraded goods could change due to structural factors affecting supply and demand conditions for these goods.) The amount of the appreciation or depreciation of the real exchange rate was often not available for the currencies of the developing countries, the cost of forward cover for the traders would be higher when the currency is pegged to a basket of currencies than when it is pegged to a single currency.

In the case of the high inflation countries, expansionary monetary policies, combined with an exchange rate policy of pegging to the dollar, resulted in a marked appreciation of the real exchange rate. To avoid this, monetary and exchange rate policies needed to be coordinated more closely. In the absence of less expansionary monetary policies, a more flexible exchange rate policy could have been adopted by implementing either a crawling peg regime or a managed float. However, under a managed float it is often difficult to distinguish between short-run random disturbances in the foreign exchange markets and the long-run underlying economic developments relevant to the adjustment of the exchange rate. Moreover, the operational demands of a managed float could strain the policy-making process, particularly in light of the inadequacy of the institutional framework and the shortage of skilled operators for the foreign exchange market. With a crawling peg the exchange rate can be adjusted periodically and systematically on the basis of different monetary policies and inflation rates, making the daily management of the exchange rate simpler.

In the case of the low inflation countries (India, Malaysia, and Singapore) the real exchange rates depreciated significantly from 1973 to 1978. Conservative monetary policies in each of these countries resulted in domestic inflation rates below those of the trading partners; under the managed float regimes, the effective exchange rates of Malaysia and Singapore remained stable while that of India depreciated, reinforcing the divergence between its domestic and foreign prices. As in the case of high inflation countries, it can be argued that in these cases as well, monetary and exchange rate policies could have been coordinated more closely to limit the depreciation of the real exchange rate. It is difficult to argue that these countries should have adopted more expansionary monetary policies, thereby accepting the higher inflation rates abroad. Consequently, more exchange rate flexibility would have to be provided to stabilize the movements of the real exchange rates. Given the institutional framework, which was similar to that in the high inflation countries (except perhaps in Singapore), a crawling peg might well have been more appropriate than a managed float for the low inflation countries as well.

Table 3
Money, inflation, real exchange rates, and external reserves, 1973-78
(Average annual rates of change, in per cent)

<table>
<thead>
<tr>
<th>Monetary</th>
<th>Domestic inflation</th>
<th>Foreign inflation</th>
<th>Inflation differentials</th>
<th>Real exchange rate</th>
<th>Reserves (in months of imports)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>28</td>
<td>17.1</td>
<td>6.7</td>
<td>10.4</td>
<td>7.6</td>
</tr>
<tr>
<td>Korea</td>
<td>27</td>
<td>16.1</td>
<td>6.6</td>
<td>9.5</td>
<td>3.3</td>
</tr>
<tr>
<td>Philippines</td>
<td>21</td>
<td>10.4</td>
<td>7.2</td>
<td>3.2</td>
<td>-0.2</td>
</tr>
<tr>
<td>Thailand</td>
<td>18</td>
<td>8.2</td>
<td>6.8</td>
<td>1.4</td>
<td>-0.5</td>
</tr>
<tr>
<td>Malaysia</td>
<td>17</td>
<td>5.8</td>
<td>7.8</td>
<td>-2.0</td>
<td>-2.2</td>
</tr>
<tr>
<td>Singapore</td>
<td>12</td>
<td>4.5</td>
<td>7.9</td>
<td>-3.4</td>
<td>-3.4</td>
</tr>
<tr>
<td>India</td>
<td>15</td>
<td>3.3</td>
<td>9.1</td>
<td>-3.8</td>
<td>-5.7</td>
</tr>
</tbody>
</table>

Sources: IMF, International Financial Statistics and Fund staff.

Annual rate of appreciation (in per cent); negative values denote depreciation.

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William R. Cline and associates

World Inflation and the Developing Countries

The Brookings Institution, Washington, DC, U.S.A., 1981, xiv + 266 pp., $15.95 (cloth), $5.95 (paper).

This book may be distinguished from the many inspired by the worldwide inflation of the 1970s by its focus on the developing countries and by its empirical bent. Cline and his colleagues cover a number of important issues, including the real economic effects of world inflation and recession on such variables as the terms of trade and external debt of developing countries; the channels through which the acceleration of world inflation was transmitted to their domestic economies; their policy responses—highlighted in four case studies—to the external shocks; and the cyclical links between the industrial and the developing countries. Although not always as thorough as one might hope, the authors paint on a wide canvas and provide many insights into a number of issues pertaining to economic development among the developing countries in the mid-1970s.

One of the authors' principal conclusions is that the severe and pervasive worsening of inflation in the developing countries in the early 1970s was primarily due to external factors. Of these the main ones are seen to be the excessive monetary growth throughout much of the world, especially in the United States in 1970–72; the poor harvests of 1972–73 and the associated rise in food prices; the worldwide cyclical boom of 1973; and the rise in oil prices, although, as is pointed out, the initial worsening of inflation rates in the developing world preceded the oil price increases of late 1973. Surprisingly, there is no explicit reference to the role of export prices, even though developing countries are generally price takers in world markets, so prices could justifiably be viewed as an external factor. In any event, the authors generally exempt the policies of developing countries from the list of factors initiating domestic inflation, although not from the list of factors contributing to its persistence.

To reach such a judgment, the authors argue that the rapid acceleration of monetary expansion, evident throughout the developing world in the early 1970s, cannot be accounted for by such internal factors as increased fiscal deficits or wage claims but is, rather, the result of a rapid growth in external reserves. This growth is then attributed, in part, to improving trade balances, but the most important cause is seen to be accelerated external borrowing stimulated by excessively liquid conditions prevailing in the industrial world.

Given this context, the book does fault the authorities in the developing countries for their failure to sterilize the avalanche of external reserves flowing to these countries in 1972–73. The authors do not, however, seem to realize fully that in developing countries central banks have limited power to control money flows. Without organized capital markets, the initial effects of the inflow of funds cannot readily be neutralized, since exporters and borrowers take their receipts directly in cash and bank deposits. Secondary effects can, in principle, be offset by raising the statutory or marginal reserve requirements of commercial banks high enough to put a brake on net lending. But raising reserve requirements could undermine the profitability of the banks and is hardly a practical course of action. The authors might have criticized developing countries more justifiably for not attempting to control inflation by reducing the deficits of the Treasury or of public sector agencies, by such measures to forestall the initial rise in reserves as export duties or taxes on capital inflows, or by not permitting the exchange rate to depreciate with the U.S. dollar.

Monetary expansion, spurred by the growth of external reserves, is found to be a major factor behind the rise in inflation in the developing countries. This conclusion stems, in part, from the authors' comparison of the results of a "monetarist" and a "real activity" model—both modified to take account of the influence of import prices and food shortages. The explanatory power of the real activity model is generally poor, while that of the monetarist model is considerable. In individual-country as well as cross-country analysis, it is found that the price of imports, the relative price of food, and the money supply are the most significant explanatory variables accounting for the acceleration of inflation in developing countries.

The four case studies (on Brazil, India, the Central American countries, and Malaysia) are good complements to the general chapters and serve to emphasize the diversity among the developing countries of both experience and policy responses to the external shocks of the early 1970s. Some countries, such as India and the Central American countries, opted for rather restrictive financial policies. Others, notably Brazil, were more concerned with sustaining investment to maintain the upward path of output. However, the omission of any African country from the case studies may have colored the authors' views in some respects. For many of the countries in Africa, it appears that enlarged fiscal deficits were a significant contributory factor to domestic inflation. Countries are also shown to have varied widely in their use of the exchange rate. Malaysia, for instance, had the good fortune of being able to partly insulate its economy from the rest of the world via an appreciation of the exchange rate, whereas others compounded their difficulties by remaining pegged to the U.S. dollar at a time when it was depreciating. More generally, Cline et al. make the point that combating inflation does not appear to have necessarily resulted in output shortfalls. In a general analysis covering 30 countries, they find little or no association between price and output performance.

The book is peppered with interesting findings on, for instance, the terms of trade, the real value of external debt, the redistributonal aspects of inflation, and the effects of the world business cycle. Occasionally, the analysis becomes too sweeping and too fast-paced to be borne out by extended analysis of the data. For instance, the claim that the worsening of deficits in the developing world in 1974 stemmed in large part from sharp acceleration in the growth of demand for imports is contingent upon a particular set of import unit value estimates for these countries. In fact, the margin of error in the statistics for that year is sufficiently large so as to reverse the conclusion; accordingly, some qualifications would have been in order. For the most part, however, the reader does get an eminently readable, straightforward, and generally accurate and relevant overview of inflation in the developing countries in the mid-1970s.

Abul K.M. Siddique

Finance & Development / June 1982
Other books received

Feili Paulaert, Jiri Shkolka, and Jef Matton
Income Distribution, Structure of Economy and Employment

This International Labor Office-World Employment Program study is an interesting empirical examination of the influence of income redistribution on economic structure and employment in Iran, the Republic of Korea, Malaysia, and the Philippines. The authors use a semiclosed static input-output model for their analyses, in full recognition of its limitations. The existence of a significant positive link between redistribution and employment emerges with progressive redistribution leading apparently to smaller increments in employment. A surprising result is the negligible effect of redistribution on imports of consumption goods, apparently due to the large share of food in this category.

V. V. Bhatt
Development Perspectives: Problem, Strategy and Policies

A wide-ranging collection of essays by a World Bank scholar, most of which have been published earlier. At the core of the book are ten essays devoted to technological change and the financial structure. Here the author shows his versatility by skilfully straddling both the general and the particular and in using the Indian experience to elucidate his ideas.

Giuseppe Pennisi
Development, Manpower and Migration in the Red Sea Region: The Case for Cooperation

This broad-ranging research report by a World Bank staff member offers extensive discussion of the issues relating to flows of migrant labor to the oil producing countries of the Middle East, remittances, and prospects for the 1980s.

Brian Griffiths and Geoffrey E. Wood (editors)
Monetary Targets

A collection of seven papers on the experience of the monetary authorities on monetary targets presented at a conference in London in May 1979. There are two comments on each paper. The primary emphasis is upon British experience, but developments in Switzerland and in other industrial countries are also discussed.

Alexander J. Yeats
Shipping and Development Policy: An Integrated Assessment

An attempt to demonstrate that transport costs frequently pose a more important barrier to the exports of developing countries than tariff restrictions and that they can have a significant effect on the cost and direction of industrial development. Drawing upon his many published papers on the subject and on the work done at the United Nations Conference on Trade and Development where he is currently employed, Yeats analyses the trends in ocean freight rates and demonstrates that these costs are compromising export competitiveness. Some suggestions are made on policies that might arrest, if not reverse, the spiral of shipping prices. This slim book is a useful addition to a literature that seems especially scant in an era of rising energy prices.

Richard H. Sabot (editor)
Migration and the Labor Market in Developing Countries

A collection of largely conceptual papers by a World Bank economist on issues in urban unemployment and rural-urban migration, the contributions to this technically rich volume do not offer much hope for policymakers faced with deteriorating rural economies and burgeoning labor forces in the cities of the developing world.

Directory of Non-Governmental Organizations in OECD Member Countries Active in Development Co-Operation

Volume I: Profiles (xxxvii + 741 pp.)

Volume II: Index (xv + 773 pp.)

Development Center of the Organization for Economic Cooperation (OECD), Paris, France, 1981, $64.95 (set).

These two volumes provide a valuable source of information for organizations in both the developed and developing countries on nongovernmental bodies dealing with development issues. The first volume carries brief information on each nongovernmental organization (NGO) and its area of interest. The second volume offers indexes by country and organization in both donor and recipient countries to facilitate access to information on the work of NGOs. Each volume has entries in English and French.

Timothy M. Shaw (editor)
Alternative Futures for Africa

Ten papers from a group of distinguished Africans and scholars on Africa compare alternative projections for population growth, food production, and the terms of trade, and discuss the implications of African countries engaging in outward-looking strategies or in self-reliance. Different aspects of the African dilemma are emphasized, among them the potential for integration, with particular discussion of existing economic cooperation schemes; dependence on Europe; and the impact of computer technology and nuclear power.

Judith B. Balderson, Alan B. Wilson, Mara E. Freire, and Mari S. Simonen
Malnourished Children of the Rural Poor:
The Web of Food, Health, Education, Fertility, and Agricultural Production

A result of the Berkeley Project on Education and Nutrition, this study examines the consequences of poverty among rural communities in Guatemala and emphasizes the key roles of health, nutrition, and the social environment in the ability of the rural poor to take advantage of educational and other opportunities. Major findings were that diet, parental affluence, and the need for children's work have a direct effect on school achievement; that schooling farmers improves their productivity; and that educating women reduces the number of children they bear. The policy implications are that poverty cannot be alleviated simply through education but through coordinating a variety of other social policies.

William W. Murdoch
The Poverty of Nations:
The Political Economy of Hunger and Population

A well-documented and vigorously argued volume covering the synergistic effect on economic development of the relationship between food and population. The author also assesses the political factors affecting national and international decisions on food production and distribution. For a general audience.

Gerry Rodgers and Guy Standing (editors)
Child Work, Poverty and Underdevelopment

An analysis of the role of children in the growth process in the developing world, this lengthy (over 300-page) volume contains nine papers heavily weighted in favor of empirical studies in Africa, Asia, and Latin America of the determinants and consequences of child labor.

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A conversation with Mr. de Larosière  
continued from page 7

Q. The balance of payments deficits of the non-oil developing countries seem to be deeply entrenched and growing. Are they sustainable over the medium to long term? If not, what measures should governments and international financial institutions like the Fund be taking to help correct the situation?

A. There has been an in-depth study on this question. In our continuous World Economic Outlook projections we have been looking at 1985 as a horizon in order to assess whether the financial situation in the international payments field could be sustainable at that time and we have come out with very interesting findings. If adjustment measures are taken and sustained during the years 1982-85 in industrial and non-industrial countries and if we keep an open international trade system alive, then the scenario that we have been developing under these assumptions, what we call our central scenario, shows that the external payments situation, the debt situation, would be manageable in 1985. Now this, of course, is a very global appreciation and there will be a number of countries in the mid-1980s, especially in the categories of low-income countries and producers of raw materials, which will encounter individually strained external situations. The debt service ratios that have been calculated in 1984-85 for those different categories of countries point to a high degree of indebtedness, not an unmanageable global situation but to high indebtedness situations for some.

Thus I would say that this analysis points to three lines of thought. The first is that the Fund should be strongly equipped financially to foster the adoption and implementation of meaningful adjustment programs, without which the sort of scenario described is not likely to happen. Second, substantial development assistance is needed especially for low-income countries if one wants to avoid the conjunction of low growth in those countries and unsustainably high debt situations. And, third, open trade and absence of protectionism is a key to the development of this rather optimistic scenario. If that doesn’t happen, then the whole logic and consistency of what I have explained falls apart.

Q. The number of cases of rescheduling of developing country debt to international banks has risen sharply in recent years. In most of these cases the country has responded to its payments problems by seeking both a restructuring of its debts and Fund support for its adjustment program. To what extent is there a need for coordination between the Fund and the banks in these cases?

A. First, let me say that one of the main lessons which has been learned from this experience is the importance of efforts on the part of all parties concerned to avoid the emergence of debt servicing difficulties. While the ultimate responsibility for debt management policy always rests with the country concerned, the creditors have sometimes taken perhaps too short term a view. We know too well of cases where lenders have been rather eager to step in when developments were favorable to them and finance levels of budget and balance of payments deficits, deficits that were unlikely to be sustainable over time, and then have been tempted to cut back rather sharply on new funding when problems began to emerge. Both borrowers and lenders must keep the medium-term outlook constantly in mind. The Fund can assist in this effort by stressing in its discussions with member countries the need for a well-formulated debt management strategy and by encouraging and facilitating the dissemination of information which lenders need to take such a medium-term view.

The experience with recent rescheduling cases has also taught us the importance of a timely response once a problem does begin to emerge. It is in the interest of both the country and the banks to recognize that a formal, multilateral approach may be required at an early stage. When a rescheduling case is obviously open, I think there is no merit in delaying the discussions and the understandings. Once discussions have begun, the Fund can use its good offices to help the parties come to a joint understanding of what is reasonable and what is possible given the constraints faced by each side. The Fund can assist the country in formulating an adjustment program which will enable it to resume normal servicing of its obligations within a reasonable period of time. It can provide financial resources to the country in support of that program and can help explain the adjustment strategy to the country’s creditors. The banks, for their part, should be prepared to reschedule on terms which are consistent with such reasonable adjustment efforts and to maintain commercial relations with the country while that program is being implemented.

Q. Calls for the reform of the international financial institutions continue to be heard in the United Nations and other forums. Do you think that one day those seeking major reforms in the structure and operations of institutions such as the Fund will reach their objective?

A. Well, I can’t tell because I don’t know the future. But I believe the Fund is a very useful, and I may say, healthy institution in a very difficult world. I am not sure that we are ready now nor that we can at the present time conduct a negotiation on a fundamental reform of the monetary system. What we have to do in the immediate future is to cope with the massive problems of the present, to cope with them in the most skillful way possible and with the sense of practicality which has always been one of the major assets of this institution. But this does not mean that we should not be thinking and reflecting on the future evolution of the system. All systems evolve. There are always, in the world and in history, currents that move systems, and we in the Fund should be very attentive in seeking to understand what is happening in the world and to enable ourselves, when conditions are more suitable, to undertake a reexamination of the fundamentals. We should be able then to bring into that discussion inventive thoughts and practical ideas.

Q. How did you perceive the role of the Managing Director when you came into this office four years ago? Has it changed since?

A. No, I don’t think the role has changed. I have always perceived, and more and more with the passage of time, that this role is essentially twofold: first, serving the member countries by responding impartially to their guidance, and, second, running the institution and animating its staff in the most effective and forward-looking manner.
Adjustment and Financing in the Developing World: The Role of the International Monetary Fund

edited by Tony Killick

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