

Criteria for policies to promote exports

Import substitution often discriminates against exports. Policies to counter this effect are numerous and should be analyzed systematically. The authors, a Fund and a Bank expert, outline how this may be done.

Luc De Wulf and Garry Pursell

Developing countries have become increasingly conscious of the limitations of industrialization based on policies of import substitution, and have, therefore, adopted a variety of measures to promote industrial exports. An important reason for this shift in focus is that the package of policies used to stimulate import substitution, and the economic situation that it typically creates and maintains, discriminates significantly against the development of exports.

This discrimination exists for a number of reasons. The first is that the import regime (based on tariffs, quotas, and exchange controls) typically supports the exchange rate at a level significantly above what it would be with a more liberal policy. This reduces the profitability of exporting and in many countries contributes to an "inefficiency illusion"—the feeling that domestic production costs exceed world prices and that local industry would therefore be unable to compete (let alone export) in a less protected economic climate. Moreover, existing export opportunities may not be developed because production for the domestic market is typically more profitable and more secure. Further, import-substitution policies often allow the establishment of activities that are simply not suited to a particular country or its particular stage of development, and may permit technical and managerial inefficiency to prevail even in industries in which the country has a fundamental comparative advantage.

Slack management, underutilized capacity, unexhausted economies of scale and specialization, lack of flexibility and adaptability, and resistance to innovation and new investments in already overcrowded markets often prevent firms from exporting their products.

Exports may be further discouraged by relatively high prices for intermediate inputs supplied by protected domestic firms, duties on imported inputs, licensing, or other import controls. The protection of domestic sales often allows industries to pass on cost increases to consumers, and so to support relatively high wages, which further increase the cost of living and the salaries required to attract foreign managerial and technical labor. Finally, import-substitution policies typically include low or zero tariffs on imports of capital equipment. Combined with relatively high industrial wages, this encourages the establishment of capital-intensive industries and the use of capital-intensive techniques, which are often quite inappropriate for the development of export markets.

Export incentives

These problems relating to the export sector could be solved by devaluing the exchange rate while removing import controls and reducing tariffs. However, reducing tariffs and dismantling import controls is usually not politically feasible, and in some cases a devaluation policy is ruled out. Consequently, many developing

countries have opted for a more pragmatic approach by implementing various combinations of export promotion measures, sometimes combined with periodic currency devaluations. In this way a number of countries—for example, Brazil, Mexico, the Republic of China, and Korea—have succeeded in obtaining a rapid and sustained growth of exports, which in turn has contributed greatly to relatively high rates of growth of national income.

The export promotion measures typically implemented can be catalogued in five groups:

- (1) those that increase the gross receipts from exports (such as export grants and exemption from export taxes);
- (2) those that reduce the exporter's costs (such as input subsidies, drawback or exemption of customs duties paid on inputs, and credit subsidies);
- (3) those that specifically reduce the profit tax liability of the exporter (such as extra tax deductions, or favorable tax treatment of export-related profits);
- (4) concessions on domestic sales in return for export performance (such as government backing of cartel pricing on domestic sales);
- (5) other measures (such as export promotion targets and the establishment of national export promotion organizations).

Because export incentives are so varied, they are often difficult to analyze and compare, yet such a cost-benefit analysis is important and should be part of the framework within which the industrialization policy is cast. It should inform policymakers how the existing, or the planned, production incentives affect production for the export versus the domestic market and how the relative incentives vary among industries. Both

Some simplified examples of effective export subsidies

		Industries				
		A	B	C	D	E
		(In pesos)				
(1) Export price (f.o.b.)		10	10	10	10	10
(2) World value of intermediate inputs		2	8	7	11	5
(3) Value added in world prices (VA _w)	(1) - (2)	8	2	3	-1	5
(4) Export grant		2	2	2	2	2
(5) Duty on intermediate inputs		—	—	2	—	3
(6) Net subsidy (S)	(4) - (5)	2	2	0	2	-1
(7) Value added in domestic prices (VA _d)	(1) + (6) - (2)	10	4	3	1	4
		(In per cent)				
Nominal rate of subsidy	$\frac{(6) \times 100}{(1)}$	20	20	0	20	-10
Effective rate of subsidy	$\frac{(6) \times 100}{(3)}$	25	100	0-200	-20	

the average level of these incentives and their structure deserve full attention.

Effective rate of subsidy

In principle, the various methods of promoting exports can be expressed as direct subsidy equivalents. For items such as import duties on inputs, export taxes, and direct export grants, the subsidy is the difference between the price paid or received by the firm and the world price. For indirect subsidies, the subsidy equivalent is evaluated in relation to an average or normal situation (such as nonpreferential interest rates). The sum of direct subsidies and direct subsidy equivalents, expressed as a percentage of the f.o.b. (free on board) value of the exported product, is the *nominal* rate of export subsidy. Since some components of the net subsidy may be negative (such as import duties on inputs), this rate may be negative or positive.

As an indicator of the export incentive, the nominal rate of export subsidy is deficient, because it does not express the net subsidy in relation to the value of the export activity. Compare industries A and B, each exporting their product for an f.o.b. price of 10 pesos and receiving an identical export grant of 2 pesos per unit. Assume that there are no other taxes or subsidies, and that no duties are paid on imported inputs. Then the nominal rate of export subsidy is 20 per cent for each industry. However, A and B import different proportions of intermediate inputs on which no import duties are paid (for simplicity, no local intermediate inputs are assumed—see the table). Industry A, for instance, imports 2 pesos' worth of intermediate inputs per unit of output, while industry B imports 8 pesos' worth of intermediate inputs. The

effective rate of export subsidy allows for this difference by relating the subsidy to the *value added* of each industry, rather than to the total value of its exports. In this way the concept is a direct extension of the effective protection concept, which



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is now frequently used to quantify the incentives to import-replacement activities given by tariffs and import restrictions.

More precisely, the effective rate of export subsidy (ERS) is defined as the percentage excess of value added measured in domestic prices (VA_d) over value added in world prices (VA_w), which is equivalent to the net subsidy (S) as a percentage of value added in world prices. That is,

$$\begin{aligned} \text{ERS} &= \frac{[\text{VA}_d - \text{VA}_w]}{\text{VA}_w} \cdot 100 \\ &= \frac{[(\text{VA}_w + S) - \text{VA}_w]}{\text{VA}_w} \cdot 100 = \frac{S}{\text{VA}_w} \cdot 100 \end{aligned}$$

Comparing industries A and B, it can be seen that while the nominal export subsidy is 20 per cent for both, the effective export subsidy is quite different because of the difference in the proportions of imported intermediate inputs. For industry A, the net subsidy is 2 and value added in world prices is 8, giving an effective rate of subsidy of 25 per cent. Industry B receives the same net subsidy, but value added in world prices is only 2, so the effective rate of subsidy is 100 per cent. Expressed slightly differently, the subsidy enables firm B to have a domestic value added of 4, which is 100 per cent in excess of the maximum possible value added of 2 if the net subsidy were zero.

In industry C, the export grant of 2 exactly offsets an import duty of 2 on intermediate inputs, giving a zero net subsidy. Hence, both the nominal and effective rates of subsidy are zero.

The effective rates of subsidy for industries D and E are both negative, but for different reasons. Whereas for E this result indicates the existence of a net disincentive (import duties on inputs exceed export grant), for D the incentive is positive but the activity is losing foreign exchange. Case E is likely to be the rule rather than the exception in countries in which export taxes or duties on intermediate inputs are not compensated by measures such as export grants or drawback provisions. Case D illustrates the dangers of excessive subsidization where there is a narrow margin between the world price of the finished product and the world value of its principal inputs. World Bank studies have shown that this has occurred in subcontracting assembly operations for export, and also in the local processing of a number of major export crops in West Africa. In the latter cases, the excessive subsidization occurred by providing the exportable

inputs to the processing firms at prices well below world prices.

This method of measuring export incentives has the advantage of enabling policymakers to evaluate the overall incentive structure as it applies to production for both domestic and foreign markets. By comparing, for instance, effective subsidies given to import-replacing industries with effective subsidies obtained by the exporting industries, it becomes possible to discuss any discriminatory incentive structure and to assess what policy tools should be drawn upon to obtain an incentive structure that would lead to a more efficient utilization of scarce resources.

Estimating effective subsidies

To calculate the effective subsidy, estimates need to be made, first, of the world value added and, second, of the net amount of the subsidy, taking into account direct and indirect subsidies as well as any other cost-increasing provisions, such as import duties on intermediate inputs.

This may involve complications when the incentives are indirect. For example, if an export firm obtains preferential credit and tax concessions, its subsidy is the difference between the interest and the tax rates actually paid and those that would have been paid in the absence of the incentive legislation. If exportable raw materials are supplied to processors for less than world market prices, the subsidy to the processor is equal to the difference between the prices paid by the firm and the f.o.b. prices at which the materials are or could be exported. In practice, it may be difficult to make the appropriate price comparisons. When an incentive takes the form of government support of monopoly or cartel pricing in the domestic market, the problem is particularly acute, since it is seldom clear to what extent profits on domestic sales would have been lower in the absence of exporting.

Because of these difficulties, it may be necessary to estimate a probable range for the value of effective subsidies rather than single values. While this is unsatisfactory, it is an unavoidable problem that is inherent in any systematic approach to the formulation of trade and industrial policies.

Rules for uniformity

In practice, countries that have implemented export promotion measures have done so in a somewhat haphazard fashion, with the result that there is typically considerable variation in effective rates of subsidy as between exported products. For

the reform of existing systems and for countries contemplating the introduction of export incentives, it is consequently of interest to consider the possible objectives of such policies and how these objectives may be achieved.

A primary objective of export-incentive schemes is to compensate the export sector for the bias in the existing incentive system favoring import substitution. This may involve two sets of instruments:

- Specific compensatory export-incentive schemes that remove existing export disincentives to the point where the effective rate of subsidy (measured with the official exchange rate) would be zero rather than negative (industry C in the table). Such schemes would ensure that inputs are supplied to exporting industries at world prices (such as through refunds of import duties paid on inputs), and that credit is supplied and taxes levied at average rates. If some inputs must be purchased from domestic producers at more than world market prices, an offsetting subsidy would be required.
- General compensatory export incentives that give a positive effective subsidy to exports so as to compensate for the overvaluation of the exchange rate associated with the import substitution policies. One general objective of these incentives is to equalize the positive incentives provided to the export sector with those given by tariff protection and other measures to import-replacement activities.

The level of these general incentives depends not only on the degree of the currency overvaluation but also on the probable response of the export sector to the incentive measures and to the level of protection that is deemed desirable for the import-substitution sector. If exports are highly responsive, the average level of positive incentives required may be quite low, since the expansion of net foreign exchange earnings may reduce the degree of currency overvaluation, thereby allowing a gradual reduction in the average level of protection to the import-substitution sector with only a minor adjustment in the exchange rate. On the other hand, if exports are not very responsive, a larger positive stimulus may be required and the possible rate of reduction of import-replacement protection may be correspondingly restricted. Although it is not an easy matter to estimate the average supply elasticity of exports, these estimates must be attempted in order to assist policymakers in evaluating the desired level of the export incentives.

General compensatory export subsidies should aim at equalizing incentives not only within the export sector but also between the export and the import-replacing sectors. This would tend to equalize the domestic resource costs of earning or saving foreign exchange. As pointed out earlier, a given effective rate of subsidy for all activities will correspond to different nominal rates of subsidy.

Deviations from uniformity

Uniformity of effective export incentives should be the starting point for an export subsidy policy, but there are a number of cases when deviations from this general principle may be appropriate.

Some countries or groups of countries may have a sufficiently large share of the world market of a given product (such as an agricultural or mineral product) that by reducing their supply they are able to increase the world price. In these circumstances a lower than average export subsidy, or even an export tax, may maximize net foreign exchange earnings. Note, however, that an overvalued exchange rate may itself constitute a sufficient disincentive to increased output in such sectors without an export tax.

It may also be desirable to impose an export tax on certain industries (especially agriculture, forestry, cattle, and mining) in situations where alternative taxes are administratively or politically impracticable or too costly.

If the structure of the exporting industry is not competitive, a somewhat lower than average subsidy may be paid in order to limit monopoly profits, especially if these would accrue to foreigners. However, it is important to take a reasonably long-term view of what constitutes a monopoly profit, as above-average profits for a number of years may attract new investment and lead to the expansion of a valuable export industry.

Finally, there may be a case for above-average effective subsidies for "infant" export industries for reasons similar to the often discussed case for protecting "infant" import-replacement industries. But extreme care should be exercised to avoid creating export equivalents of the many import-replacement infants that never grew up.

Policy instruments

So far we have discussed effective export subsidies and various policy instruments used to stimulate overall export performance. However, some instruments

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Export credit financing as a development policy

An examination of the special problems faced by the developing world in financing exports, and some pragmatic solutions.

Bingu Wa Mutharika

Recent developments in international economic relations, more particularly the international monetary problems and the world energy crisis, have brought into sharp focus the need for more pragmatic policy-oriented action toward the promotion of exports. Many developing countries have consequently placed great emphasis on trade expansion as a way of solving the balance of payments, unemployment, or general economic problems which have resulted in mass poverty. The international community—particularly the United Nations and its specialized agencies, including the Fund, and the World Bank—are stepping up their efforts to aid nonindustrialized countries in this field.

Export credit financing as a policy objective is relatively new in most developing countries. This is partly because in the past, primary products had a guaranteed market in the industrialized countries of Europe and required no special promotional effort, and partly because export credit financing is not understood by many policymakers or their advisors. The argument against export credit financing in developing countries is that manufacturing has not yet reached the level of sophistication that can attract medium- and long-term credit. The purpose of this article therefore is to examine whether export credit financing can be used not only to encourage small-scale and medium-scale enterprises to go into the export business, but also to establish locally based industries geared to the export market. To answer all the questions generally raised on this topic is beyond the scope of this article. The present analysis attempts merely to assess the potential of export credit, to point out its salient features, and to identify major policy issues.

Nonindustrialized countries have numerous problems in their export promotion efforts. They are generally heavily dependent on one or two primary commodities for the major portion of export earnings—in some countries such as Zambia primary commodities bring in up to 98 per cent of export earnings. In most of these countries manufactured products are not exported, and even where they are, the range is very narrow. Moreover, these countries operate within a system in which traditional rigidities in trade policy force them to export their products to countries which are their traditional importers. It is difficult to protect these economies which rely on so few exports from the disequilibria caused by fluctuations in the prices of these commodities on the world market.

Most developing countries have to contend with a severe lack of adequate resources among individual traders which makes them unable to finance exports. The banking system is often dominated by overseas banks which until recently dealt exclusively with nonlocal exporters. Facilities are inadequate for providing the medium-term and long-term credit which is essential for competition between suppliers. In addition, most developing countries do not have specialized institutions for export financing, such as export credit insurance or export credit guarantees. At government level, the increases in export bills deplete the foreign reserves, and this makes it difficult to set aside funds to finance further exports. This becomes a vicious circle, since it then constitutes an obstacle to the introduction of new products.

The absence of a clearly defined policy for granting incentives to exporters makes exporting unattractive for many entrepre-

neurs. Commercial banking is still by and large geared to metropolitan requirements established during the colonial era and, therefore, tends not to provide the type of incentives normally granted in developed countries. Furthermore, heavy competition from the more experienced expatriate traders often drives indigenous traders out of business.

Another problem is restrictive policies on imports in the industrialized countries, such as quotas and quantitative trade barriers, which make it difficult for nonindustrialized countries to increase their exports to these countries. This is particularly so in the case of manufactured products. Primary commodities, moreover, face heavy competition from synthetics and substitutes in the technologically advanced countries, which tends to limit the amount of exports, irrespective of any effective export drive.

A dynamic trade policy

Export credit financing as an instrument for development must be part of a flexible overall trade policy. Traditionally, the basic objectives of a trade policy in the developing countries have been: (1) to diversify the composition of trade, as well as trade partners, through changes in regulations; (2) to increase foreign exchange earnings, usually by increasing exports of primary commodities; and (3) to smooth out fluctuations in prices of certain primary commodities on which a country depends for exports through collective bargaining power—such as commodity agreements in cocoa, coffee, oilseeds, sugar, and copper.

Experience has shown that these objectives are rudimentary both in effectiveness and coverage. Developing countries should now consider a new policy orientation to achieve the following four objectives. First, instead of struggling for “price stabilization,” the developing countries should seek to relate commodity prices to

the prices of manufactured goods imported from developed countries, after these prices are suitably adjusted for inflation, recession, and fluctuations of major currencies. The essence of this policy is that it is unrealistic to try to maintain stable prices for commodities in a world of fluctuating values and prices.

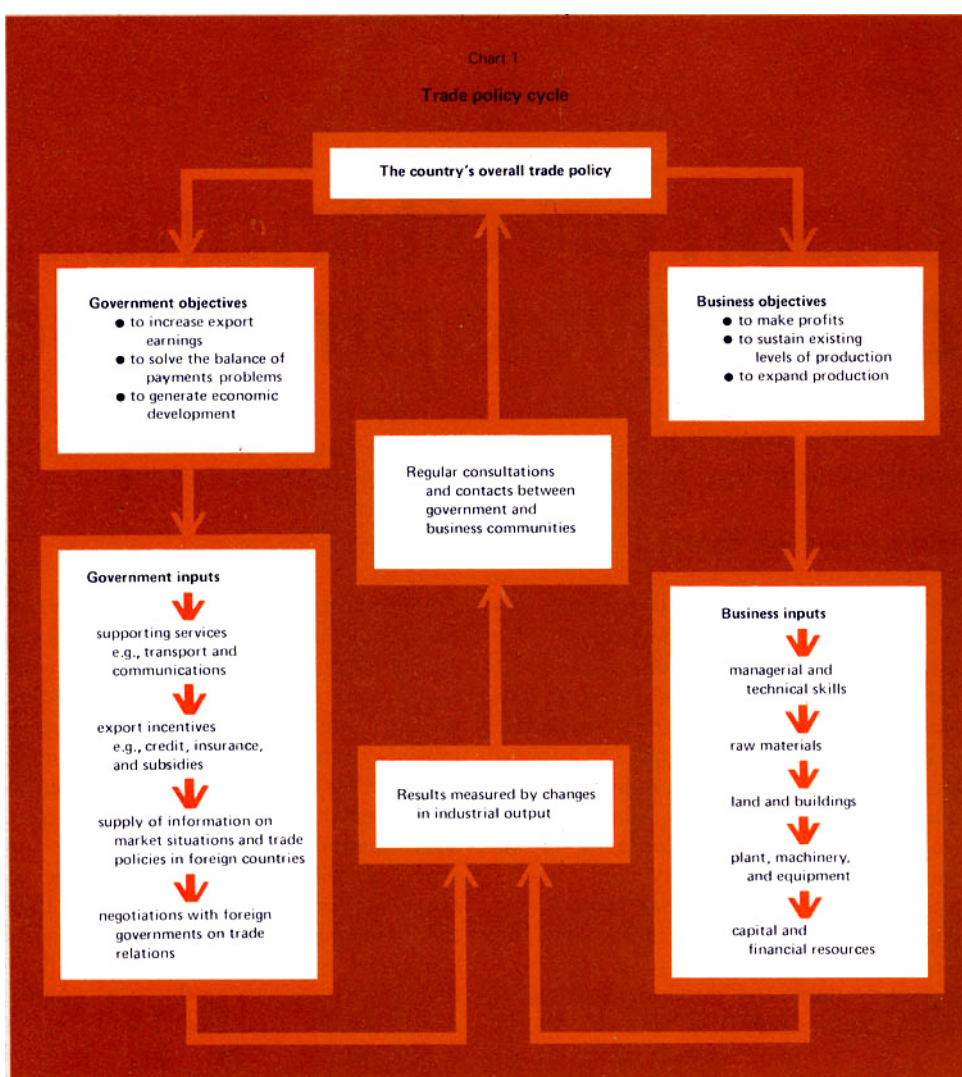
Second, the indigenization of the trade sector should be aimed at, by granting greater incentives to encourage locally based entrepreneurs and local traders to enter the export trade business. Much of the export trade of the developing countries is in the hands of foreigners, and this seriously affects foreign resources to the extent that part of the proceeds from export earnings goes toward remuneration of these expatriates and is remitted abroad.

Third, appropriate export promotion institutions should be established to ensure coordination of trade policy with the overall development plans. The establishment of export credit insurance and export credit guarantee schemes should constitute an integral part of new trade institutions. Finally, there should be changes in production structures where the objectives should specifically determine what products should be developed and for what markets.

Government-business relationship

Most policymakers seem to take for granted the relationship between the government and the business community and do not provide for effective and regular consultations. They fail to realize that it is largely the private sector that actually carries on trade at the grass-roots level. This results in constant discrepancies between policy objectives and achievements, as well as a lack of appreciation of government policy by the business community. A new trade policy should ensure that the government meets regularly with leading manufacturers, bankers, and traders to acquaint them with new policy changes and to learn their problems. This relationship is illustrated in Chart 1. At some point along the cycle, the end result should be to accelerate the rate of growth of the economy and to provide increased employment as part of the development process.

Therefore, the government should ensure that: (1) it directs and controls the use of raw materials through an appropriate pricing policy and the prevention of monopolistic practices, so as to ensure that all production units have access to them; (2) the entrepreneurs already in business are encouraged to stay and be more productive; (3) exporters of products of sig-



nificant national interest should be given additional incentives such as export bonuses based on performance over a three-year average; and (4) market research information is available to exporters concerning conditions in international markets, both in relation to manufacturers of products of national interest and to small traders whose financial resources or

levels of operation do not permit extensive research.

The problem of finance

The basic problem which exporters in nonindustrialized countries generally face is the lack of adequate capital resources to cover their many risks—the main ones being commercial, institutional, and political risks. Commercial risks include a buyer's default to pay, a buyer's failure to accept the goods ordered for whatever reason, and a buyer's insolvency. Institutional risks include insolvency or default by the supplier, insolvency or default by the manufacturer, and insolvency or default by the bankers in the foreign country which has opened the letters of credit. Political risks arise out of actions by government resulting in exchange transfer restrictions; delays in executing contracts; import restrictions which may be introduced after the contract of sale has been made; war, revolution, or civil disturbance; increased costs in insurance or freight occasioned by diversion of routes following political uprisings; and



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any other actions by governments in the importing countries which may disturb the smooth flow of merchandise. Although the impact of these risks cannot be readily determined in the case of small-scale and medium-scale exporters, commercial banks attach great importance to them.

The basic problem for the new small-scale and medium-scale indigenous exporters often revolves around their inability to obtain credit from commercial banks. However, they also have trouble in obtaining credit information about foreign buyers, because banking practices require a trader to establish his creditworthiness or to provide collateral security before his credit application can be considered; the size of the operation is generally too small to provide the security required by commercial banks. Other inhibiting factors for the potential small-scale exporter are the stringent exchange control regulations and trade barriers and restrictions such as licensing, taxation, and payment requirements.

In purely commercial terms the banks, on the other hand, have difficulty in determining the credit requirements and obtaining adequate information on the ability of an exporter to comply with the terms of export credit. The standard information required by lending institutions includes the financial status of the individual or his business; his ability to raise collateral security when required; the duration of the credit period; the turnover of the business; and the type of merchandise involved—all of which may not be readily available from the usual sources. Moreover, the banks face a greater risk in financing exports of new products, especially if these are relatively small in volume and value and do not have a market that is fully assessed. A fundamental problem is the fluid market structure in which both the lending institutions and the borrowers operate, often aggravated by political uncertainties. All these problems combine to make export trade rather hazardous and unattractive both to would-be entrepreneurs and to commercial banks, especially where no government backing is forthcoming.

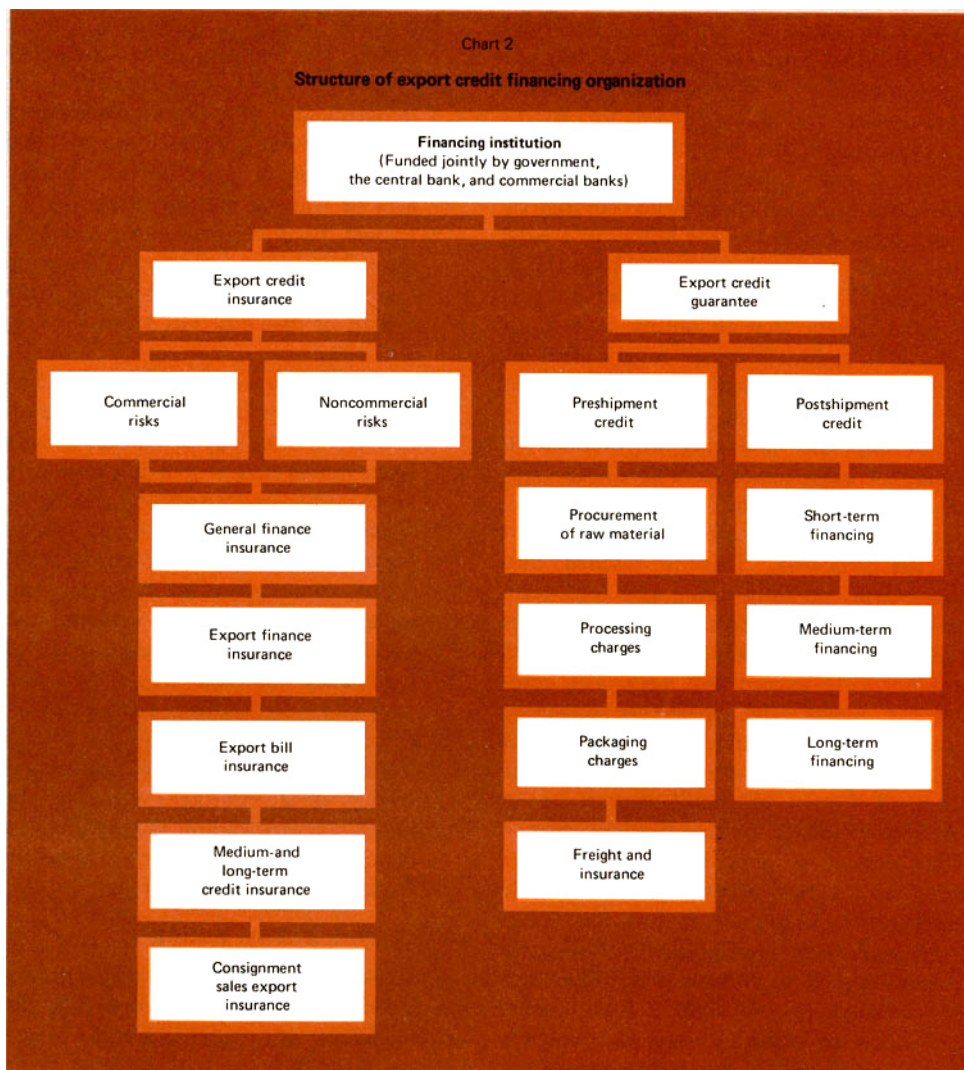
Methods of export financing

There are two methods of export financing—export credit guarantees and export credit insurance. Chart 2 shows the structure of an export credit financing organization. This may be a government-owned institution and would undoubtedly require huge financial resources. Experience indicates that the commercial banks, development banks, central banks, and appro-

priate government ministries should be represented on the Board of Directors of such an institution to ensure coordination of the government's financial and economic policy. Nevertheless, it should have autonomy in its day-to-day decisionmaking, although it should report to the government at agreed regular intervals. The importance of an export credit institution is that the exporter who does not have adequate resources to grant credit to the buyer may resort to such an institution to obtain them. The methods most commonly used are described in some detail in the following sections.

The *export credit guarantee scheme* provides a financial cushion for exporters and is generally confined to preshipment and postshipment credit of varying duration. This may be divided into "suppliers' credits," which are provided by the exporter to a foreign buyer of his products, and "buyers' credits," which are provided by a credit institution (often a bank) in the exporter's country to enable the foreign buyer to make cash purchases from the exporter.

The most common form of export credits are: cash payment, either on a cash-on-delivery basis or on confirmation of the shipment of the order; promissory notes issued by the purchaser undertaking to pay by a given date; an open account where an exporter maintains an account with a buyer overseas from which exports are financed (usually practiced in cases of holdings of subsidiary or affiliate companies); documentary bills such as bank drafts or bills of exchange, which is the most common form of payment for trade transactions; and a letter of credit, which is an instrument issued by a bank in favor of an exporter whereby the bank undertakes to pay the exporter a given sum of money against evidence of trade documents. There are two types of letters of credit—revocable and irrevocable. The irrevocable letter of credit gives a large degree of security and though very expensive, it is preferred in certain trading transactions where security is of utmost importance. Finally, there is shipment on consignment, where the exporter retains the title to the goods



and only releases it when payment has been received after the goods have been sold by the purchaser. Here the main consideration is the personal knowledge and good trade relationship between the exporter and the purchaser. Export credits are in turn divided into preshipment and postshipment credits.

Preshipment financing is intended to provide working capital during the period between the receipt of the order by the exporter and the dispatching of the consignment (see Chart 2). This type of credit is of great importance, especially for small-scale indigenous manufacturers or exporters who do not have access to large financial resources. An individual exporter may need financial resources at several stages—to procure raw materials, to cover processing charges, to meet costs of packaging and freighting, and to cover insurance. In the case of an export house, the preshipment credit may be required to meet the cost of procurement of goods, packaging, freight, and insurance.

The rate of interest in preshipment credit generally varies between 5 and 7 per cent a year, and up to 90 per cent of the f.o.b. value of exports is generally covered. The length of the credit depends upon the value of the exports. Ordinarily preshipment credit is given up to 12 months, but in the case of large consignments, it may extend up to three years. The collaterals which may be required by commercial banks include letters of credit; title deeds to fixed assets such as land, buildings, plant, and machinery; non-tangible assets such as mining, fishing, or leasehold rights; current assets such as savings, time, or fixed deposits in banks; or personal guarantee.

Postshipment financing is intended to assist the exporter to have access to capital during the period between the shipment of his consignment and the receipt of the proceeds. This is divided into short-term, medium-term, and long-term credit. Short-term credits go up to 90 per cent of the f.o.b. value of exports, and do not normally exceed 180 days. The commercial banks give exporters advances against the production of valid export bills and usually require collaterals in the form of letters of credit, export credit insurance policies, or shipping documents. The interest is generally around 6 per cent, but varies according to domestic market conditions.

Medium-term postshipment credits are often confined to consumer durables and to intermediate and light capital goods. Generally an exporter may discount his bills with a bank at face value, less inter-

est and banking charges, in order to obtain ready cash. If the exporter is unable to obtain payment from the foreign buyer, he is normally covered if he has export credit insurance. The rate of interest for medium-term postshipment credit is between 6 and 7 per cent and nearly 80 per cent of the value is covered; the credit period may be from two to five years in developed countries.

The conditions for long-term postshipment financing are similar to that for the medium-term, except that the period covered extends to between five and ten years. The importance of this form of financing arises in the case of purchases of heavy capital goods such as plant and machinery and transport equipment. Because of the heavy risks involved in the transactions, this form of financing is usually undertaken by governments, or multinational corporations with huge financial backing.

Export credit insurance may cover both the "commercial risks" and the "political risks" described earlier. Some of the systems of export credit insurance are briefly described below.

- *General export insurance*, under which the export credit insurance institution (in some countries a department of the government) indemnifies an exporter against loss as a result of government policies, acts of war, or civil disturbances.
- *Export finance insurance*, which is intended to indemnify a banking institution against loss resulting from a loan or discount bill granted to an exporter.
- *Export bill insurance*, where a foreign exchange institution is indemnified in the event of losses arising from nonpayment of a bill issued to an exporter in respect of exports.
- *Medium-term or long-term credit insurance*, where the insurance institution undertakes to indemnify an exporter from losses incurred on goods already exported as a result of insolvency of the buyer or new restrictive legislation introduced in the buyer's country.
- *Consignment-sale export insurance*, which is a contract whereby the insurance institution indemnifies an exporter for loss incurred by him from sale of goods overseas.

Suggested policy action

It is evident from this analysis that if developing nations wish to encourage the establishment of export-oriented industries, a thorough study should be made

of the nature and problems of export financing. Some basic policy instruments which governments might apply in conjunction with the overall development policy can be defined.

The developing countries must draw up their trade policy in such a way as to ensure that it fits into the overall development policy. This will provide a general sense of direction to industrialists, traders, and commercial banks. Experience shows that most of these countries operate trade policies which are incompatible with a changing world.

An operative framework should be established to assess or monitor effectively the activities of commercial banks and other financial institutions which operate in developing countries but have headquarters or major interests overseas. Schemes for export credit guarantees and export credit insurance are a way in which governments in developing countries can establish some control over the financial policy of these organizations. This can be achieved through the establishment of institutions such as state trading corporations, industrial credit and development banks, or an export credit guarantee corporation such as that established in India.


Due to the comparatively unfamiliar nature of export credit financing in developing countries, this is perhaps the least understood aspect of trade policy. Accordingly, the advantages of introducing such a scheme tend to be thwarted by the conventional wisdom of "letting sleeping dogs lie." Experience in developing countries where export credit financing has been tried, shows that expatriate commercial banks and traders strongly resist the introduction of export credit financing by governments, arguing that it would merely duplicate existing services. In addition, some indigenous economists also maintain that the scheme is expensive to introduce or operate. In such cases, the government will have to weigh these factors against the need or desirability of encouraging the establishment of domestically based enterprises as part of its overall industrialization policy so as to reduce foreign dependency.

An effective export policy must be supported by extensive sales and promotional organization both within each region and in overseas markets. This is an area in which the government has to play a decisive role, since market studies require financial and professional skills beyond the reach of most indigenous enterprises. Exports cannot be taken for granted; they must be painstakingly developed,

expanded, and maintained. Developing countries should build up a store of knowledge on market structures, consumer preferences, business practices, and government policies (especially regarding license requirements, tariffs, and quantitative restrictions) of the countries to which they wish to export.

One way to do this is for governments in these countries to divert some resources toward rigorous training of their ambassadors and trade or information attachés in the techniques of trade promotion and negotiation. This task can be facilitated by establishing contacts with international trade organizations which have vast trade information and research capacity at their disposal. Among them are the World Trade Organization or the Research Institute of America in New York; the International Monetary Fund and the World Bank in Washington; the Board of Trade and Industry in London; the International Chamber of Commerce in Paris; and the International Trade Center in Geneva.

There is a large market potential in the developing countries themselves as judged purely by import statistics of consumer, intermediate, and capital goods. Hence, in addition to the development of trade channels in the traditional partner countries, new efforts should be made to devise ways of exploiting this market, usually by trade incentives such as export bonuses, liberal foreign exchange allowances, and less rigid credit requirements. An effective scheme for export financing should also give priority to intraregional trade.

Export credit financing is an important aspect of trade expansion and should constitute an integral part of development policy. Its basic purpose should be seen as a catalyst to development. Its advantages can be summed up as follows: first, indigenous entrepreneurs would have access to adequate funds to enable them to enter into competitive export trade business. Second, the commercial banks would be more willing to grant credits when collaterals are available in the form of export credit insurance backed by government. Third, the availability of financial resources would enable the establishment of new export-oriented industries and thus promote development. Finally, new business would increase employment opportunities and can thus be seen as a way of combating unemployment. The sum total of all these factors is that governments in the developing countries would be ill advised to ignore the potential which such a scheme offers for economic development. 

Structuralism and financial liberalization

To combat deficiencies in the economic structure of less developed countries, it is necessary to integrate capital markets and promote financial growth. The author examines the views of structuralists and of recent proponents of financial liberalization.

Vicente Galbis

There are now two apparently contradictory, but in a sense complementary, views on the causes of economic instability and the conditions necessary for stable economic growth in the less developed countries (LDCs). The structuralist approach of Raul Prebisch and associates attributes much of the instability, in the form of open or repressed inflation, currency devaluation, and balance of payments crises, to structural deficiencies. The more recent view (which I shall call "neoliberal") of Ronald I. McKinnon and Edward S. Shaw sees "financial repression"—caused by monetary mismanagement, both in the form of excessive growth of the money supply and erroneous selective credit policies—as a major contributing factor to exacerbating the structural deficiencies inherent in the economies of the LDCs. In their opinion a major indicator of financial repression is the widespread prevalence of negative real interest rates.

The two views are grounded on the observed fact that the economies of the LDCs are fragmented and thereby subject to wide disparities in the returns to various units of the factors of production (land, labor, and capital) and in output prices. These imperfections in the markets result in the misuse of available resources. The coexistence of old and modern tech-

nologies and the lack of adequate manpower training are at the root of the problem. But although both views recognize these facts, they differ markedly in their practical recommendations because of differences in their analytical framework.

The structuralist view emphasizes that in order to break the vicious circle of financial instability and structural deficiencies, public policy must first focus directly on remedying structural deficiencies through social and economic policies rather than on restricting the money supply and government expenditures. The neoliberals recommend the contrary. Noting that interventionist policies toward domestic price fixing, import substitution, and financial markets have not only failed to overcome structural deficiencies but have themselves become major obstacles to sound financial policies, they advocate "financial liberalization" and monetary restraint as the best way to overcome (in the long run, of course) the structural deficiencies which characterize the LDCs.

A useful synthesis of the two views might be as follows. Interventionist financial policies (in particular interest rate fixing) tend to cause rather than overcome financial repression and inflation, which are major obstacles to the efficient allocation of resources. But the need for government intervention through other policies may be justified, especially in the LDCs, by the usual considerations of conventional theory: the provision of overhead capital or infrastructure, including human capital; the existence of economies of scale in productive activities which cannot be efficiently exploited by the private sector; external economies and diseconomies; monopolistic or imperfect market structures; and the maldistribution of income. Inflation does not inevitably follow either structural imbalances originating with the growth process itself or intervention policies. This has been shown by some LDCs, such as Mexico, which are subject to the usual structural imbalances and have followed "dirigist" policies, but have nevertheless been able to grow with substantial price stability for extended periods. Such examples suggest that fiscal and monetary policies can perform a proper stabilizing role in the growth process. In this regard there is a need for moving toward greater simplification and coordination of financial policies—goals that can probably be best accomplished within the framework of a comprehensive "indicative" development plan, that is a plan which is mandatory only for the public sector but provides a

set of complementary incentives and disincentives for the private one.

The structuralist view

Structuralism, as a comprehensive approach to development theory and policy, concentrates on the role of rigidities of supply and demand in various factor and product markets—in particular those of the foreign sector—in originating and fostering disequilibria (see Chenery in the reading list at the end of the article). Financial matters are only a small and relatively unimportant part of the structuralist approach, but it is impossible to separate them from the whole body of structuralist theory and policy, as shown by the Latin American structuralist writings. For this reason, attention is focused on structuralism in Latin America, where a great deal of emphasis has been placed on explaining and, to some extent, justifying financial disequilibria in LDCs.

Latin American structuralist writings have emphasized the dependence of the small developing economy on erratic prices for its exports, which are concentrated in a few primary products, and on the long-term deterioration in its terms of trade. The structuralists blame fluctuations in exports of primary commodities for periodic bouts of economic depression, followed immediately (or perhaps with a lag) by inflationary pressures. Their view maintains that there is little that monetary policies can accomplish directly against these exogenous shocks. Deflationary policies accentuate the downward swing in income resulting from a fall in exports, and are equivalent to accepting economic depression and a period of slow growth. On the other hand, offsetting the deficit in external demand by expanding domestic credit in order to stabilize the domestic economy is likely to result in a further imbalance of the foreign sector, as imports accelerate with the pace of

domestic demand. Thus, an import substitution policy is thought by the structuralists to be necessary to balance the external sector in the long run and to insulate the domestic economy from foreign shocks in the short run.

The structuralists sponsor industrialization policies for similar reasons. They believe that the economy's dependence on inelastic foreign demand for agricultural exports from the LDCs must be reduced, as must the direct effects on the economy from fluctuations in agricultural output caused by adverse weather. Monetary policy can do little to overcome the agricultural cycle and the deteriorating terms of trade for agricultural products. Often a massive import program is needed to offset crop failures, which places a heavy burden on the capacity for adjustment of the foreign sector. This stresses again the importance of a flexible import substitution policy.

Economic imbalances

The maldistribution of income is often regarded as the source of social and political tensions that erupt in economic imbalances as the power of different groups and classes shifts with economic development. (This has been called the interest group theory of inflation.) There are excessively large concentrations of landholdings in some areas and excessive segmentation in others. At the same time, the economy is afflicted with oligopolistic elements in industry and radical labor movements. Heavy emphasis is, therefore, placed on policies such as agrarian reform, which are expected to remedy the inefficient concentration or dispersion of resources. In spite of this, there is a dilemma in the structuralist analysis of the effects of skewed income distribution in the LDCs, because it assumes (in common with the neoclassical approach) that the more concentrated the distribution of income is, the more growth may be possible, as savings are largely made by capitalists and not by the peasant and working classes.

Structuralists accept the premise that budget deficits resulting from irresponsible increases in public outlays and expansionary monetary policy can cause excess total demand and rising prices. They are also conscious that the gains from public industrialization programs, when they involve excessive government expenditures and inflation, accrue only during the initial stage and soon become an obstacle to growth. Finally, the structuralist view recognizes that inflation normally worsens the balance of payments and the distribu-



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tion of income, thereby tending to aggravate social and political tensions. On the other hand, it rejects the simplistic view that overambitious public policies are the sole and ultimate cause of inflation in Latin American countries, and argues that even these policies may be justified because of the need to stimulate the flow of savings. However, structuralists fail to recognize fully the negative relationship between the stimulation of private savings, particularly in financial forms, and the process of inflation and financial repression. This approach pays no attention to interest rates and makes only passing reference to the money supply.

To sum up, the structuralists maintain that without programs designed to cope directly with shocks emanating from structural sources, there can be no economic stability when there is progress. The dilemma can be avoided if appropriate policies are designed to cope with structural deficiencies. However, in practice, maintaining economic stability is extremely difficult in the LDCs because of the complexity of the policies needed to cope with structural shifts.

The "neoliberal" view

For the neoliberals, financial development is an essential ingredient, if not a prerequisite, of economic growth. This view emphasizes the fragmentary nature of markets in LDCs, in particular that of the capital and money markets, which leads to the misuse of factors of production and the inefficient allocation of resources. Financial repression makes it difficult to introduce efficient techniques because of the combined effect of large indivisibilities in investment goods and the inability of potential small-scale entrepreneurs to obtain loans to finance investment. Many of the governments in the LDCs have intervened extensively in the private markets for goods and resources, as well as in financial markets, but their interventions have generally tended to disrupt, rather than improve, the market as an indicator of relative values. Governments should therefore abandon intervention policies, particularly in the financial sphere, thereby creating the conditions for the emergence and growth of financial institutions. The main practical prescriptions of the neoliberals are (1) to design a careful, noninflationary monetary policy and (2) to encourage flexibility of interest rates to respond to market forces. Both prescriptions are summarized in a policy of high (at least positive) real interest rates (nominal rates minus the rate of

inflation). As a corollary, the neoliberal view is in favor of indexation of financial contracts in the initial stages of financial reform, because it allows the authorities to raise real interest rates substantially and immediately.

The most fruitful approach to the rationale for freeing interest rates and pursuing high real interest rate policies seems to be that taken by McKinnon. It is summarized in his "complementarity hypothesis" between the private demand for real monetary balances and investment, which he contrasts to the short-run neoclassical hypothesis of substitutability. First, the demand for real monetary balances increases with the average rate of return on capital (instead of decreasing, as in the neoclassical hypothesis). This effect comes about because of the positive relationship between the rate of return on capital and the ratio of investment to income, which McKinnon thinks is an important independent determinant of the demand for money in the LDCs. Second, investment is positively related with the real rate of interest at the very low (typically negative) real rates prevailing in inflationary LDCs. The reason alleged here is that such low rates prevent the effective channeling of financial resources to support investment activities. This effect, called the conduit effect by McKinnon, implies that a rise in the real interest rate increases investment (instead of reducing it as in the neoclassical hypothesis). However, for real interest rates above a certain level, the neoclassical inverse relationship applies (see Galbis, 1975). The conclusion that follows is that the accumulation of real monetary balances and the capital stock are complementary processes and are both helped by the rise in real interest rates toward their equilibrium levels.

Interest rates and growth

As a corollary, the rise in real interest rates that results from simultaneously executing a financial stabilization plan, and the liberalization of portfolio and interest rate regulations, promotes growth, both in the short run and the long run. This contrasts with the so-called orthodox or monetarist doctrine on stabilization policy, which has been attributed, rightly or wrongly, to some individuals of the Chicago school and has been dubbed a policy of "shock treatment." This doctrine, notes McKinnon, only takes into account the necessary restriction of the money supply, which frequently results in a severe credit crunch during the

initial stages, making it socially and politically very unpopular. However, with financial reform, the authorities need not fear adverse consequences on investment and output from attempts at reducing the inflation rate. Higher real interest rates tend to raise the total volume of savings and increase the degree of financialization, acting as a "conduit" for investment.

A more elaborate approach has shown the McKinnon theorem to be consistent with neoclassical theory, although applied in a state of disequilibrium. Another disadvantage of this approach is that it shows that the policy of high real interest rates is growth-promoting in the LDCs, even if it does not help to restrict private consumption (increase the supply of savings), because, on the whole, saving is so low that it provides little scope for greater capital accumulation. Improvements in financial intermediation are translated into improvements in the "quality" of the capital stock, in the sense that its marginal efficiency is raised, and they generate increases in productivity per man-hour (see Galbis, 1974).

The neoliberal financial prescriptions for the LDCs extend into related areas of public finance and the role of foreign capital. Both McKinnon and Shaw advise that once domestic financial reform is under way it is much easier for governments to undertake sensible reforms in these other areas without jeopardizing political and social goals. In particular, they recommend a tax reform to increase the progressivity and neutrality of taxes, and they indicate that it could be done with a minimum of administrative machinery in the form of a value-added tax (VAT), which should be extended also to cover import duties. The VAT should be accompanied by steep duties on luxuries, but luxury taxes should not discriminate between domestic and foreign goods. In this way, the LDCs would be able to raise the competitive performance of their economies. With inflation substantially reduced and domestic real interest rates and savings at a high level, there would be much less need for foreign borrowing because the current account of the balance of payments would tend to be much closer to equilibrium. Indeed, LDCs would then probably need to impose controls on excessive private capital inflows (instead of worrying about outflows) at the same time that they reduce their demand for official funds from international organizations and lift their massive controls on foreign trade.

The contrast between the neoliberal and the structuralist views may superficially resemble the earlier controversy between monetarists and structuralists. In its extreme form, monetarism attributes inflationary pressures mainly to excessive money supply and implies that limiting its rate of increase to the growth of real income is the only requirement for monetary stability. Yet, despite empirical evidence in favor of this technical proposition, monetarism is an easy target for structuralists to attack because of three main factors.

First, monetary orthodoxy is related—or at least, so it has been believed—to a strange system of neoclassical assumptions concerning the uniformity of inputs and outputs and the equalization of rates of return, wages, and prices by the market mechanism. This set of assumptions, as noted by structuralists, runs counter to empirical observations in the LDCs. Second, the explanation of inflation by excessive growth of money is not in conflict with the structuralist explanation that the social and political factors are ultimately responsible for excessive money supply and thereby for inflation. Third, structuralism rejects the self-discipline of shock treatment as a cure for inflation, on the grounds that it affects those segments of society already badly affected by inflation.

The neoliberal approach is an improvement on both its monetarist and structuralist predecessors in the field of financial policies. Like the structuralists, the neoliberals also reject the monetarist or orthodox view (which they improperly identify with the neoclassical approach), but provide a sensible alternative to their shock treatment policies. They criticize orthodox stabilization efforts on the grounds that they are dangerous if not accompanied by a process of liberalization of repressed markets during their implementation and that they are inadequate for maintaining stability in the long run. Thus, today there is not so much an emerging controversy between two new schools as a real breakthrough in the formulation of realistic growth-oriented financial policies in the LDCs—policies whose effectiveness can be empirically supported.

Some aspects of the neoliberal approach are particularly useful when applied to the problems raised by structuralists. The creation of a wide and flexible capital and money market would greatly help the LDCs to face fluctuations in export earn-

ings by accumulating reserves during periods of upswing and drawing them down and/or increasing foreign borrowing during periods of downswing. This approach would largely diminish the need for import substitution policies, which often involve substantial costs in administrative machinery and misallocation of resources.

Another interesting aspect of the neoliberal approach is that it goes beyond aggregate magnitudes into the sphere of selective credit policies—carrying further than the monetarists the analysis of the role played by deficient monetary and fiscal policies in the generation of repression and inflation. Selective credit policies often increase the fragmentary nature of the economy by inducing further misallocation of resources and by creating substantial costs of transformation among productive activities as they are favored to different extents at different periods of time, thereby inducing massive shifts in inputs and an increase in the degree of risk throughout the economy. For instance, in many countries the attempt to expand the housing industry by regulations limiting the interest rates on mortgages has frequently resulted in the decline in mortgage lending and mortgage institutions,

when the opposite was intended. In an attempt to solve this problem, the authorities have frequently resorted to direct portfolio regulations, but these have inhibited development of financial institutions and have introduced serious distortions in other markets.

The neoliberals cast doubt on the old views about the conflict between growth and the distribution of income. First, savings of the masses may be stimulated by high real interest rate policies which increase the degree of financialization. This source of savings may surpass in volume the savings of capitalists. Second, even if redistribution of income results in a decrease in total savings, accumulation by the middle and lower classes, facilitated by the development of the financial system, may have greater impact on economic development because of the parallel accumulation of human capital. Unemployment is lowered and the productivity of investments is raised.

The structuralist views, on the other hand, appear especially relevant at the present time, when it hardly seems appropriate to suggest that the balance of payments deficits caused by steep rises in oil prices can be averted without a genuine

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restructuring of productive activities. Nevertheless, this recycling problem, as it has been termed, is only an enlarged version of that of transferring resources efficiently, but on an international scale. Thus, an extension of the policies proposed by the neoliberals in the international sphere to create new financial channels would help to resolve these problems.

A monetary theory for LDCs

The neoliberal approach has arisen out of a desire to provide policy prescriptions for the urgent problems of the LDCs; its theoretical and empirical documentation is insufficient, though highly promising. Thus further elaboration and testing of its hypotheses are urgently required to provide a consistent and efficient policy framework.

A natural starting point for further elaborating the neoliberal view would seem to be the modern neoclassical approach to monetary theory and policy, with its potential capacity to deal with cases of "primitive" as well as developed financial systems. In particular, its crucial concept of the required rate of return on capital, developed by Tobin and his associates, is as useful under conditions of freely adjusting interest rates as with "sticky" interest rates or rules of thumb concerning allocation of credit, as is typical in the LDCs. In fact, one of the interesting conclusions of neoclassical theory is that interest rate controls and other market restrictions, which imply the prevalence of credit rationing, make the impact of monetary policy actions more powerful and more unpredictable than they are in a more developed, smoother credit market.

It has been argued here that the neoliberal approach to monetary policy in the LDCs, though imperfectly formulated, represents a breakthrough in the desired direction. It contains the explicit assumption that interest rates on financial assets frequently fail to perform their role as an adjustment mechanism—or only do so imperfectly—in the capital markets of the LDCs, thereby accepting the prevalence of credit rationing. This means that disequilibrium analysis is the essence of this theory and that any policy recommendations should be based on this fact. For instance, as noted earlier, an improvement on McKinnon's own explanation of his complementarity hypothesis is provided by a neoclassical two-sector model in a state of disequilibrium in which interest rates are below the market equilibrium level (see Galbis, 1974). **ED**

Agricultural credit and the small farmer

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have especially low interest rates for small-scale producers as a form of subsidy. However, World Bank experience with such subsidized interest rates has been discouraging. First, low rates attract large farmers who can quickly use up the funds otherwise available for smallholders, even though they could borrow from normal commercial sources. Second, the lending institution is weakened if interest rates are fixed so low that it cannot cover its costs; it then becomes increasingly dependent on the government for financial support, which may not always be forthcoming. Third, a low lending rate means a low interest rate on deposits which discourages savings in rural areas. Consequently, the Bank recommends that the cost of inputs or the price of outputs be subsidized, instead of

the interest rate, where subsidies are considered desirable in order to aid a particular group.

Future program

The Bank has lent substantial amounts for agricultural credit—\$1.5 billion in total, most of it in the last six years. In the Bank's lending program for fiscal years 1969–73, \$3.4 billion was allocated to agricultural development, of which 36 per cent was for crop and livestock credit projects. The second five-year program allocates more than twice this amount—over \$7 billion—to agricultural development. We expect that the proportion going into credit projects of all kinds will not fall below the 36 per cent of the previous period; in fact, the Bank's increasing emphasis on smallholder farm production virtually assures that the proportion will be larger.

The ability of the Bank to carry out this program will be determined very much by the availability of funds. In this respect,

the replenishment of the International Development Association (IDA), which finances our concessionary credits to the least developed countries, is a major concern. The Fifth Replenishment of IDA funds will be of critical importance if the pace of agricultural development in the poorest countries is to be sustained.

A potential source of new resources for agricultural development in general, and farm credit in particular, is the proposed International Fund for Agricultural Development. This fund was recommended at the World Food Conference in 1974 and received further impetus at the Seventh Special Session of the General Assembly of the United Nations in September 1975.

With the growth of existing sources of finance, supplemented by new funds, agricultural credit policy is very much a live issue. Therefore, the Bank is constantly searching for the most effective ways of using the funds available for rural credit to promote more rapid economic development. **ED**

Toward a new framework for international commodity policy

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stocks as the primary stabilizing mechanism must make provision for frequent re-examination of price ranges in the light of the level of purchases and of sales by the stock. Moreover, if prices remain depressed and large stocks are accumulated, export quotas may be necessary. It should be recognized, however, that whereas the combination of stocking and quotas can in principle effectively defend

an agreed floor price, the situation is asymmetrical with respect to the ceiling. Once quotas have been lifted and stocks have been exhausted, there is no way of defending the ceiling. The difficulty of reaching agreement on price changes and quota shares has proved historically to be the Achilles' heel of commodity agreements. It is to be hoped, therefore, that some objective standards or automatic formulas can be agreed to which would minimize the need for extended negotiations on these matters.

Although the UNCTAD program has been criticized as overambitious, it lays out a set of constructive ideas and a pattern of arrangements that can be initially pursued on a more limited basis. The major obstacle in practice is likely to be not the problem of financing the buffer stock fund, on which so much attention has been devoted by UNCTAD, but rather the ambiguity of the pricing principles for commodity agreements that the program sets forth. While reduction in fluctuations is given as the primary goal, the difficult-

to-define and correspondingly controversial objective of "equitable" and "remunerative" prices over the long run is also included. Any effort to achieve both of these goals through a single instrument is bound to complicate the negotiations enormously.

Regardless of the degree of success achieved in negotiating individual commodity price stabilization agreements, a need will exist for more general arrangements to stabilize export earnings. For some commodities (such as bananas) buffer stocks are simply not practical. More stable prices, moreover, will not always mean more stable earnings as, for example, when a drought has reduced the supply of an export crop. Nor is it likely that a

comprehensive series of price stabilization agreements can be quickly concluded or that all commodities of export interest to developing countries will be covered.

On the other hand, it would be a mistake to view even the recently liberalized IMF compensatory financing arrangement as a full substitute for price stabilization agreements. The distinctive contribution of the latter is their moderation of the distortions in resource allocation that result from uneconomic price signals during boom-and-bust commodity cycles. Nor is compensatory financing directly responsive to the importing countries' interest in avoiding the inflationary shock to their economies of shortages and soaring prices for primary products. Earnings stabiliza-

tion, therefore, should be regarded as a valuable complement rather than as an alternative to individual commodity price stabilization agreements.

One final point bears emphasis. The export markets for the primary products of the developing world are overwhelmingly in the developed countries. As the experience of the last several years dramatically demonstrates, sharp cyclical fluctuations in the industrial countries have even more profoundly destabilizing effects on the exports of primary producers. The business cycle may never be completely conquered by the industrial countries, but more effective measures to tame it would make a major contribution to stability in the Third World. **ED**

Criteria for policies to promote exports *continued from page 27*

are more adequate than others. Allowing all exporting firms to purchase their tradable inputs at world prices and exempting manufactured exports from export taxes are specific compensatory measures and give no effective export subsidy. They should be considered first. While they are relatively simple to administer, they have the disadvantage of removing protection from local suppliers of intermediate products. These local suppliers may have to be compensated accordingly.

As a general principle, subsidies should be provided in such a way as to deal as directly as possible with the distortion they are intended to correct. Since the basic problem is usually the overvaluation of the exchange rate, theoretically the best procedure is to pay an export grant based on net foreign exchange earnings. This has the additional administrative—if not political—advantage that its amount is apparent, both to the government and to the subsidized firms, and that it can be varied according to the firm's net foreign exchange earnings.

However, if for some reason export grants are not feasible—they may attract countervailing duties in some importing countries, or their budgetary cost may be all too visible compared with the other export-incentive schemes—it may be advisable to resort to other forms of export subsidy, such as input and credit subsidies, tax holidays and concessions, and extra profits on sales to the domestic market. Whatever the form of these subsidies, they should attempt to equalize the percentage of the total value of the subsidies to net foreign exchange earnings between exporting industries. How-

ever, the problem with an array of individually small subsidies is that their combined advantages may not be fully appreciated by investors, nor easily calculable by the government. In addition, they may be difficult or even impossible to adjust so as to maintain a fixed relation to net foreign exchange earnings between industries. They may also introduce some undesirable distortions, and their effects on exports may be uncertain. Credit subsidies and tax concessions that reduce the cost of capital, for example, will tend to bias input decisions in favor of capital-intensive techniques. Input subsidies may lead to the overutilization of the subsidized input, while monopoly advantages for sales in the domestic market have an uncertain relation to export performance.

The implementation of an export-incentive program will encounter some administrative and budgetary problems. These are, however, not necessarily more difficult to cope with than those associated with import-replacement industrialization. In particular, the net budgetary cost of a given economic expansion through further import replacement may well exceed the net budgetary cost of the same expansion achieved by an economically desirable level of export promotion.

From an administrative point of view, it will be difficult at times to allocate inputs and profits between domestic and export sales when firms supply both markets, and the firms themselves will be tempted to adjust their accounts to obtain the greatest benefit from the export-incentive program. Appropriate controls should limit such abuses, but care should be taken that these controls do not stifle the activities that are meant to be stimulated.

The budgetary costs of direct export grants, as noted earlier, have the advantage of being explicit. The potential exporter can assess how they alter his export possibilities, and policymakers, aware of the cost of their policy, will be less likely to continue them beyond the point where they cease to fulfill their objective. Indirect export subsidies lack these important advantages. However, although involving a loss of government revenue, and having similar budgetary implications, they may be more attractive politically, precisely because the budgetary cost is less apparent, and because they may be less likely to attract countervailing duties by importing countries.

The export promotion policies of a number of developing countries are currently being studied in a World Bank research project directed by Bela Balassa. The results of this study should throw some light on the problems mentioned in this article.

At the international level, as part of a long-run objective of reducing trade barriers, there is some opposition to the use of export grants. In view of this, and because of the potential advantages to them of a properly administered system of export grants, developing countries may wish to press the issue that export subsidies should be viewed in a development context during the next multinational trade negotiations. One possible way of doing so might be to distinguish between developed and less developed countries and to permit the latter group of countries a limited recourse to some incentive schemes which would continue to be prohibited when used by developed countries. **ED**