March 1984 / Volume 21 / No. 1

pecial Section
AFRICA

Finance & Development

A quarterly publication of the International Monetary Fund and the World Bank

Finance & Development

Bahram Nowzad
EDITOR

Shuja Nawaz
MANAGING EDITOR

Joslin Landell-Mills
ASSISTANT EDITOR

Sheila Meehan
EDITORIAL OFFICER

Richard Stoddard
ART EDITOR

Deborah Salzer
GRAPHICS ARTIST

ADVISORS TO THE EDITOR
Andrew Crockett
Barend de Vries
Howard Handy
Paul Isenman
Arturo Israel
Claudio Loser
Guy Pfeffermann
Alexander Shakow
Alan Tait
U Tun Wai
David Williams
Christopher Willoughby
Shahid Yusuf

Finance & Development is published quarterly in English, Arabic, French, German, Portuguese, and Spanish by the International Monetary Fund and the International Bank for Reconstruction and Development, Washington, DC 20431, USA (USPS 123-250). Second class postage is paid at Washington, DC and at additional mailing offices. • English edition printed at Lancaster Press, Lancaster, PA. • English edition ISSN 0015-1947. • Opinions expressed in articles and other material are those of the authors; they do not necessarily reflect Fund or Bank policy. • New readers who wish to receive *Finance & Development* regularly should apply in writing to *Finance & Development*, International Monetary Fund, Washington DC 20431, USA, specifying the language edition and briefly stating the reasons for their request. • The contents of *Finance & Development* are indexed in Business Periodicals Index, Public Affairs Information Service (PAIS), and Bibliographie Internationale des Sciences Sociales. An annual index of articles and book reviews is carried in the December issue.

Cover drawing: the Mount Washington Hotel in New Hampshire, site of the Bretton Woods conference.

March 1984/Volume 21/Number 1

Finance & Development

A quarterly publication of the International Monetary Fund and the World Bank

The Editor welcomes views and comments from readers on the contents of the journal.

The IMF's role in a changing world

A conversation with William B. Dale, Deputy Managing Director of the Fund

F&D ***The Fund has been much in the news for the past 18 months, largely because of its role in assisting countries with their debt problems. Has the Fund been "bailing out" commercial banks?***

Dale The short answer is "No." In fact, we've "bailed the banks in." We have indeed encouraged greater commitments from banks to countries with Fund-supported programs than probably ever before. We have been insisting that, in order for programs to be fully financed, additional bank commitments would be necessary. So, depending on how one wants to calculate it, resources made available by banks have been a multiple of the resources provided by the Fund; the ratio has ranged from 3 to 1 to as high as 10 or even 20 to 1, depending on the country. If you take simply the new exposure of banks to program countries you get one ratio; if in addition you include the rescheduled debts you get a very much higher multiple.

F&D ***In the case of some major debtors, the Fund has taken the initiative in helping resolve debt problems by bringing together various parties and by coordinating actions, which is a departure. Is the Fund going to adopt a similar leadership role regarding all major debt questions in the future?***

Dale I wouldn't like to put it at either end of the spectrum—that the Fund would be guiding or coordinating all the time in the future, or that it's just an *ad hoc* thing, not to be repeated. It is being repeated. We're into the second year of the operation for Mexico. We have gone back and supported Brazil for a second time. We've done it several times now in the case of Yugoslavia, for example. The Fund stepped into a coordinating role on a pragmatic case-by-case basis, and we'll have to continue to do that in the future if we see the need for action on our part. I wouldn't want to say that the need would extend indefinitely into the future, but I think that there will be clearly such a role for the Fund in these matters for some time, although no one would want a return to the market situation more than we do.

F&D ***The Fund has also been in the news because of the difficulties it has had in supplementing its resources through the Eighth Review of Quotas. Is it simply that Fund quota increases have become embroiled in the legislative complexities of the U.S. Congress, or has generalized support for international organizations diminished in the United States?***

Dale All of the above, and perhaps more besides. Yes, I think the spirit of internationalism, not only in the United States but also in many other countries, is less marked than it was at earlier stages in the postwar period. Countries are having greater difficulty because of their domestic budgetary pressures.

The situation, as far as Fund financing is concerned, is clearly more difficult than in earlier periods. One of the problems is that the Fund is much more in the news and therefore much more visible to people. The knowledge and perception of how the Fund's financial mechanism works has become important. In view of actions just taken—to move the remuneration rate (that is, the rate of interest, loosely put) to contributors of resources to the Fund closer to the market rate—it is now much more possible

to say that the cost of the Fund to the taxpayer is minimal, almost nothing. Therefore, the net cost to the contributing governments will be very small compared with what it was in earlier periods. I think that should help the process of understanding. But, of course, it won't erase these difficulties. They are inherent to the epoch we live in, I'm afraid.

F&D *Is it, then, simply a question of public relations?*
Dale I think it's a matter of several things, but not public relations in some sort of fluffy sense. It is very much a matter of public education. Many of us, myself included, who have had occasion to speak to different groups in the United States and outside, have found a genuine lack of information, and in many cases a hunger for information, about how the Fund actually operates.

F&D *Do you think that there is now, as compared with, say, three years ago, a greater realization among countries that major adjustments must be made to restore the balance of payments situation? If so, what do you think has brought this about?*
Dale Yes, I certainly do think there is a greater realization. What has brought it about? Well, the most obvious and immediate point is that the debt crisis *per se* has brought the need to the fore in many countries that earlier had been able quite easily to borrow enough to take care of their payments problems. But, I think it goes rather deeper than that. I think the appreciation of the adjustment problem has been growing for the past four or five years. When the second oil price increase occurred in the late seventies, we came to the realization that higher energy prices were here to stay, and therefore, instead of financing with a light emphasis on adjustment (as was the case after the first oil price increase), we needed to reverse what had been the response in the mid-seventies. It was from that time that the heavier emphasis came on adjustment with relatively less emphasis on financing. That doesn't mean that financing is no longer a problem—as we've just been discussing, it is a problem insofar as official financing through the Fund and in association with the Fund is concerned.

F&D *And how is the Fund assisting in this adjustment process?*
Dale I think it is little recognized that currently the Fund has about 45 programs in operation that it is supporting financially. That is a very large increase over what it had in force during the seventies and an even larger increase over earlier epochs. But apart from that, the Fund has actually been advancing its "technology," as I would call it, of programs and, in particular, the monitoring and the evaluation of programs. For example, the Fund has assisted countries in developing mechanisms that, at an earlier stage, provide evidence of whether a country is on track or may be veering off track in regard to fiscal operations in particular, but also in the conduct of monetary policy.

We have also been placing much more emphasis, as we have had to with the evolution of major debt problems, on putting programs in a medium-term framework. We are constantly looking ahead to see what kind of debt-servicing situation countries will be faced with, not merely at the end of a one-to-three-year program, but toward the end of the decade. We want to see exactly what the whole concept of "a sustainable balance of payments adjustment" means, as one looks ahead, to try to avoid debt problems in the future.

There are a number of other areas also where we have made a lot of progress. One is the monitoring of debt itself. With the development of the international banking statistics project in the Bureau of Statistics, we are achieving a much better and more current statistical picture of debt among countries. In particular, we have become much more conscious of the need to have information so that we can see when the debt of a country starts moving toward the short end of the maturity spectrum, because that usually is a signal that there may be trouble ahead. In all these ways we have developed, what I like to call the technology of designing and monitoring programs.

F&D *The technical assistance component of the Fund's work has become more active and important recently. Do you see this aspect of the Fund's operations expanding in years to come?*
Dale Probably. It is difficult to make an informed quantitative projection on this because it depends on requests from member countries. It certainly is given very strong support by the Executive Board and the management, and from that point of view it could expand. We have gone into new fields, the most important of which is debt management assistance, a relatively new field for the Fund. But in other areas as well, such as fiscal management and central banking, we have been trying to tailor technical assistance somewhat more directly to the program needs of countries.

F&D *There have obviously been changes in the global environment regarding trade; in the past few years there have been signs of increasing protectionism and other forms of restrictions. What can the Fund do to check this tendency before it takes hold?*
Dale Not enough, but the Fund can do quite a bit. We have been emphasizing more and more in the Article IV consultations (that is, the annual consultations with member countries on their exchange rate arrangements,) a technical analysis of trade restrictions and a fuller provision of information to the Executive Board, so that it can take views when it discusses the country reports. This is especially so for the larger countries, which tend on the whole not to be users of Fund resources. Also, it is very important that the great majority of Fund financial programs put emphasis on the need for countries to stop the march of protectionism and often to roll it back, partly because that is the proper thing to do from an international point of view, but, much more important, because it supports a genuine competitive and sound development of their economies.

F&D *We have seen considerable volatility in exchange rates in recent years, although the main problem currently seems to be the strength of the dollar, which in turn is related to high interest rates. How does all this affect the Fund's surveillance responsibilities?*
Dale Surveillance responsibilities are among the most important of the responsibilities of the Fund. The principal manner in which the Fund handles the responsibility is through the conduct of the Article IV consultations. Indeed the current Article IV is founded on the proposition that the underlying domestic economic situation in a country is the basis for the establishment of proper exchange rates.

I think there is no doubt that, first of all, there has been more volatility of exchange rates, especially among major countries, than can be explained by changes in the so-called fundamentals, and that there has been a problem from time to time of overshooting, either in the direction of overvaluation or undervaluation, of rates of exchange. First, these are extremely difficult to diagnose, because views, including those of competent, unemotional professionals can vary on these issues. Second, even where one can reach agreement among a variety of people that rates have overshot or undershot, getting from there to actual policy actions to correct the situation is often extremely difficult. Sometimes one can see the possibilities of changes in monetary policy that perhaps are not too fundamental or dif-

ficult. But, more often, as I think is the case now, it is something much more difficult, such as a change in the basic mix of fiscal or monetary policies that a country, or indeed a group of countries, is following. That is a much more difficult area in which to obtain concrete policy action. But it is something the Fund concerns itself with and pronounces on, for example in the Annual Report and, of course, in less visible communications with member countries.

F&D ***The operations of the Fund have expanded enormously in recent years, but the size of its staff has not. Can the Fund go on performing its increasingly important functions without a major expansion of its personnel resources?***

Dale There is no doubt that productivity in the Fund has gone up substantially in recent years and also that the stresses and strains on staff resources have increased considerably during the same period. This is evident in the number of programs we have in operation, many of them requiring more frequent reviews. I have no doubt that the staff will have to expand; how much, we shall have to see. But we do have a particular constraint which cannot be solved quickly with just additional numbers, and that constraint is at the level of mission chiefs and those who may be in the process of becoming ready to lead missions. Those people simply must have the experience in the Fund and in the process of Fund negotiation and evaluation. Also, I think it remains important for the Fund to present not only the image but also the reality of being a lean and agile organization with a relatively simple and uncomplicated organizational structure.

F&D ***You have now been in the Fund for just over 21 years, first as the Executive Director for the United States and for the past ten years as Deputy Managing Director. What strikes you as having been the main changes in the nature of the Fund as an institution in these years?***

Dale Well, obviously it has become much more busy, much more active, and much more complicated. Just to give a figure or two: during my first year in the Fund there were, I believe, about 50 meetings of the Executive Board. In contrast, in the last several years, the number of Board meetings has always been in excess of 200. While the number of Board meetings may not at first glance seem to be too good an indicator of activity, in fact it probably, *grosso modo*, is not a bad one. I mentioned earlier the large number of programs in place at present, far more than we ever had before.

When I came to the Fund in 1962, the Fund had only one financial window. I pride myself on having played an active part in the establishment of the Compensatory Financing Facility which came into effect in 1963—the second window. Now, depending on how one wants to do the counting, we have at least four, and as many as seven or eight, facilities.

So, the arrangements of the Fund are far more complex and, what is obviously more to the point, the world economy is a great deal more complicated. Many of the individual economies are a great deal more complex—both industrial and developing countries. The range of difference among developing countries, I think, is far greater now than it was 21 years ago. To end on a brighter note, I also see a very great increase, I would call it a dramatic increase, in the skills and capabilities of a great number of officials in the developing world.

F&D ***Finally, in this 21-year period, what is the one thing (if there is one) you would have liked to have happened differently?***

Dale If I try to focus on what would have made the greatest historical difference, I'm torn between two things. First, if the fiscal deficit of the United States in the second half of the sixties had been smaller, and if, as a consequence, the rate of inflation in the United States had not begun to move up dramatically, then the events of the early seventies and the demise of the Bretton Woods exchange rate system might perhaps have been averted.

The second thing is a sequel to the first. If a way could have been found under which the major exchange rate realignment of 1971, and later the beginning of floating in 1973, could have been faced up to earlier, the history of the recent period in international monetary affairs might have been different.

Adjustment programs in Africa

The experience with Fund-supported programs, 1980–81

Justin B. Zulu and Saleh M. Nsouli

Faced with mounting domestic and external financial imbalances, numerous African countries adopted adjustment programs supported by the use of Fund resources during 1980–81. The experience of these countries in carrying out their adjustment efforts establishes that the achievement of the objectives of programs has been closely linked to the effective implementation and adaptation of the requisite policy measures to reflect changing domestic and external conditions.

Prior to 1980, the economic and financial problems facing the African countries were manifested in sluggish economic growth, rising inflation rates, and widening deficits on the aggregate current account of the balance of payments. Real per capita income declined during the 1970s, while the rate of inflation approximately doubled, reaching an average annual rate of over 20 percent during 1977–79. The combined current account deficit of the balance of payments rose from about $4 billion in 1974 to close to $10 billion annually in 1978–79. The financing of these deficits partly by foreign borrowing led to a dramatic increase in external debt, from $15 billion at end-1974 to $46 billion at end-1979, contributing to a near doubling in the debt-service ratio. Further, international reserves declined sharply.

These deteriorating economic conditions reflected a number of adverse external factors and some domestic factors. Following the increase in oil prices in 1973–74, the industrial countries experienced a sharp decline in economic activity accompanied by a substantial acceleration in inflation. For developing countries these events tended to have an adverse effect on demand for their exports and to worsen their terms of trade. The increases in oil prices further directly aggravated their already widening current account deficits.

Domestic financial policies, which were not promptly adapted to the emerging situation, also played a role. In particular, many African countries had embarked on ambitious public investment programs and had rapidly expanded government current expenditures. In some countries the improving prices of primary and mineral products of the late 1960s and early 1970s had contributed to an increase in government revenues and export proceeds that allowed such expansion. As demand for exports tapered off and their terms of trade deteriorated, budgetary receipts started to lag behind the growth in expenditures and budgetary deficits widened. Increasingly, these deficits were financed by domestic bank and external borrowing. The expansion in credit to the government sector, accompanied in some instances by an accommodating stance on credit to the private sector, increased the pressures on domestic prices and the balance of payments.

This study covers countries that had programs in effect during 1980–81. These were the Central African Republic, Equatorial Guinea, Ethiopia, Gabon, The Gambia, Ivory Coast, Kenya, Liberia, Madagascar, Malawi, Mauritania, Mauritius, Morocco, Senegal, Sierra Leone, Somalia, Tanzania, Togo, Uganda, Zaïre, and Zimbabwe.

Countries generally resorted to price controls, consumer subsidies, maintenance of low producer prices, administrative controls on imported goods, and, in many cases, exchange rates were maintained at levels incompatible with financial stability. In particular, the import restrictions resulted in shortages of consumer as well as intermediate and capital goods. The imbalances were reflected in a widening of parallel markets for goods and foreign exchange. The growing distortions contributed significantly to the slowdown in economic activity.

Adjustment programs

Accordingly, as the African countries entered the decade of the 1980s, they faced major financial and structural problems that urgently needed to be addressed. A number of these countries worked closely with the Fund to design and implement appropriate adjustment programs during 1980–81. The total amount committed under programs supported by use of Fund resources rose sharply from SDR 455.2 million at the end of 1979 to SDR 1.8 billion at the end of 1980 and further to SDR 4.3 billion at the end of 1981. Purchases nearly doubled in 1980 and more than doubled in 1981, reaching a record SDR 1.7 billion.

In providing financial support for adjustment programs, the Fund follows its guidelines on conditionality, which were reformulated in 1979. These guidelines emphasize the need to encourage members to adopt corrective measures at an early stage of their balance of payments difficulties. They also provide that, while the normal period of a stand-by arrangement will be one year, in some cases they may extend up to three years; that a flexible approach to the treatment of external borrowing in adjustment programs needs to be adopted; and that due regard has to be given to the domestic social and political objectives, the economic priorities, and the circumstances of members—including the causes of their balance of payments problems. Within this general framework, considerable flexibility has been maintained in the application of conditionality. Particularly in countries with severe structural problems, greater emphasis has been placed on supply-oriented policies and increased financing over a sufficiently long period to allow fruition of the effects of the measures taken.

Objectives

While the Fund provided resources to support appropriate adjustment programs, a primary concern of the African countries that adopted such programs was the achievement of a sustainable level of economic growth. However, the key to such sustainability was the establishment of domestic and external financial stability. If a country had high levels of domestic inflation, often reflecting excess demand pressures, savings and investment would be discouraged, leading to a drop in economic growth. Similarly, if a country faced protracted external imbalances, the shortage of foreign exchange could result in a curtailment of important imported inputs and capital goods. In addition, the distortions arising from an inappropriate exchange rate could undermine both the export-oriented and import-competing industries. Again, therefore, the sustainability of economic growth would be impaired. Accordingly, in the general design of these programs, the three basic and interdependent objectives were to promote economic growth, to reduce inflation, and to improve the current account position of the balance of payments over the medium term.

Considerable emphasis was given to economic growth in the programs under consideration; most aimed for an increase in economic growth during the program year. Nearly all programs attempted to contain inflation to about 15 percent per annum, implying for most a reduction in inflation from the previous year. In a number of cases, however, an increase was projected. This reflected a certain degree of pragmatism as to how much, if at all, inflationary pressures could be controlled in the span of one year, and in some cases reflected necessary adjustment of controlled prices within the country. Although programs generally emphasized an improvement in the external sector position, medium-term considerations did not always allow for an improvement in the current account position or in the overall balance of payments in the span of one year. This was particularly so in the case of supply-oriented programs, where an expanded level of investment financed by external financial assistance could involve an increase in associated imports contributing to a short-term widening of the current account deficit. However, such investment was viewed as contributing to the productive capacity of the economy and as being conducive to increased exports or reduced imports over the medium term.

Policy framework

In attempting to attain these objectives, each program was designed differently. Each addressed the specific problems of the country concerned, took into account the macroeconomic relationship imposed by the institutional framework, and set the quantitative targets for the instruments selected. Since most of the African countries under consideration faced, and continue to face, deep-rooted structural problems, the programs generally emphasized supply-oriented policies, designed to bring about structural change, and financial policies aimed at reinforcing the structural adjustment process and limiting the growth in demand. These entailed measures to (1) affect growth, (2) enhance financial management, and (3) improve the external position.

First, since economic growth is heavily dependent on the level of domestic capital formation, provided that the investment undertaken is allocated efficiently, the programs incorporated measures to strengthen the development planning process. In recommending these measures, the Fund relied heavily on the expertise of the World Bank. In addition, to improve resource allocation and mobilize domestic savings, as well as to encourage private sector investment, the programs paid close attention to pricing policies. In particular, the programs aimed at reductions in the scope of price controls and subsidies and, where applicable, the adoption of realistic producer prices. Where public sector enterprises played an important role in production, the operations of public enterprises were also carefully reviewed, and these were, in a number of cases, streamlined. In other cases, where these enterprises were considered not viable on efficiency grounds, they were phased out. Clearly, public enterprises cannot be judged solely on a profit basis when they provide vital social services. However, social services should be specifically financed in the budget; profit-oriented public enterprises should not be called upon to provide them.

Second, given the size of the financial imbalances in most countries, financial stability could not be reestablished without significant measures to improve the fiscal position. On the revenue side, a number of programs included tax measures designed to expand the revenue base and to increase the elasticity of the tax system. In many cases, improvements in tax collection procedures also contributed considerably to revenue performance. On the expenditure side, there was usually an emphasis on limiting the growth in current expenditures, largely through more efficient expenditure controls, closer scrutiny of new government hiring, restraint in granting salary adjustments, and economies in administration and other expenditures. Capital expenditures were generally assessed against the availability of resources and carried out within the context of the macroeconomic framework of the development plan. Because of the attempt to improve revenues

and contain expenditure increases, nearly all programs aimed for a reduction in the ratio of the government deficit (excluding grants) to GDP.

As monetary policy was heavily dependent on fiscal developments in many of the countries under consideration, the more restrained fiscal policies generally allowed the monetary authorities to follow a more flexible credit policy toward the private sector, contributing thereby to the promotion of private economic activity. For countries where the growth of credit to the private sector had been relatively modest in the previous year—and these constituted the majority of the program countries—the programs aimed to increase the growth of private sector credit. Within the context of monetary policy, most programs involved adjustment in interest rates with a view to improving domestic resource allocation, enhancing the process of financial intermediation, and promoting domestic savings and investment.

Third, the programs generally addressed three main issues affecting the external sector: restrictions on current international transactions, exchange rate policy, and external debt. Restrictions had usually been imposed in response to rising imbalances; without such controls, there would have been, at the prevailing exchange rate, a shortage of foreign exchange in the country and pressures on the exchange rate. Such restrictions were thus symptomatic of the need for adjustment. All programs, therefore, attempted to deal with the underlying imbalances in order to enable the country to reduce the restrictions.

The exchange rate, with appropriate supporting policies, is a major instrument in the adjustment process. An inappropriate exchange rate generates cost-price distortions that have a negative effect on consumption and investment as well as on the trade balance, as it tends to reduce the profitability of export-oriented and import-competing activities in the country. These effects all have a detrimental impact on economic growth. The appropriateness of the exchange rate level, therefore, was carefully reviewed in the context of the programs under consideration. In several cases, exchange rate action was taken. A notable example is Somalia, which devalued its currency by 150 percent in domestic currency terms during 1981-82 (see box). Uganda also devalued its currency by about 100 percent over May 1981-June 1982. In both instances, dual exchange rate systems were introduced on a temporary basis. Another example is Zaïre, which devalued its currency in mid-1981 by about 67 percent. Finally, given the importance of achieving a sustainable external debt position, Fund-supported programs aimed at containing the external debt burden to levels consonant with the debt-servicing capacity of the country.

Performance

It is difficult to assess the performance of a country on the basis of a few quantitative indicators, insofar as progress made in certain areas in the adjustment process may be unquantifiable and the effects of measures taken may start to be felt only after a considerable gestation period. For instance, the effects of measures contributing to a reduction in economic distortions may take time to materialize fully and cannot be readily quantified. Nonetheless an impression of the progress made can be gathered from examining two basic yardsticks: the targets of the program and the previous year's performance. Economic growth targets were achieved in about one fifth of the cases; the inflation targets were met in nearly half the cases; and the external sector targets in about two fifths of the cases. The ratios of savings and investment to GDP were generally close to targets. While the ratios of government revenues (excluding grants) to GDP were in most cases close to targets, government expenditure ratios generally exceeded targeted amounts. Because of this, the budgetary deficit (excluding grants) as a proportion of GDP was considerably exceeded in two thirds of the countries. The rate of growth of net credit to the government, accordingly, generally did not conform to targets. Further, credit to the private sector was exceeded in numerous cases. Reflecting these developments, net domestic credit growth exceeded the targets in about half the cases.

Joseph J. Diana for F&D

Justin B. Zulu
a citizen of Zambia, is the Director of the Fund's African Department. He holds a Ph.D. in economics from the University of Colorado. He has held senior government positions in Zambia.

Robert Townsend for F&D

Saleh M. Nsouli
a U.S. citizen, is Assistant to the Director of the Fund's African Department. He holds a PhD in economics from Vanderbilt University, where he taught, and has published widely in many areas of economics.

Given these deviations, how did the countries perform relative to the preprogram year? In terms of economic growth, there was a considerable improvement in 40 percent of the cases. Inflation was reduced in over half the countries and the current account position of the overall balance of payments improved in about half the countries. Turning to the indicators of policy, there were no major changes in savings and investment. Government revenue (excluding grants) as a ratio to GDP increased sufficiently to offset the rise in the ratio of government expenditures to GDP, bringing about an improvement in the government budget (excluding grants) as a proportion of GDP in about 60 percent of the cases. On the monetary front, in most cases net credit growth to the government sector remained about equal or declined, while credit growth to the private sector was nearly equal to or exceeded the previous year's rates. Overall net domestic credit expansion was in most cases nearly equal to or less than the previous year's.

There is a striking correlation between the attainment of the objectives and the observance of policy measures. In 14 programs in which all or a major part of the policy measures were observed, most of the targets were attained. In 9 cases, where the policy measures were generally not observed, the objectives were not attained. Accordingly, in 23 of the programs there was a close correlation; only in 7 was the relationship not established.

When slippages in implementation occurred, they were primarily due to the emergence of unforeseen developments, an inability to mobilize sufficient political support for the requisite adjustment measures, limitations in the administrative infrastructure, overoptimistic targets, and delays or shortfalls in net inflows of development assistance. However, unforeseen events were encountered both by countries that succeeded in implementing the programs and by countries that did not. This suggests that adjustment can be kept on track if unforeseen factors are handled by readapting and reinforcing policies to limit the deviations from the adjustment path. This would imply the intensification of the adjustment efforts, for which a strong political commitment would be necessary.

Review and prospects

During the last four years, the economic conditions generally in Africa have not shown signs of improvement. Economic growth has remained below the population growth rate. Inflation continued to rise in 1980–81 to an average annual rate of about 25 percent, but tapered off somewhat

Somalia's adjustment experience, 1981–83

Against a background of virtual stagnation in economic activity and increasing financial imbalances, the Somali authorities launched in mid-1981 a major adjustment effort, supported by two consecutive stand-by arrangements with the Fund ending in January 1984. The programs included major measures on both the supply and demand sides, which together with favorable weather conditions have contributed to promoting economic growth, reducing inflationary pressures, and strengthening considerably the external sector position.

Somalia is basically a pastoral economy, with over 80 percent of its population (estimated at 5 million) engaged in livestock raising and agriculture for their livelihood. With an extremely small industrial sector, Somalia is highly dependent on imports for consumer and investment goods.

During the 1970s, a series of internal and external developments, including a severe drought in 1974–75, the outbreak of regional hostilities in 1977–78, and an ensuing inflow of refugees, adversely affected economic performance. By the end of the decade, widening budgetary deficits, financed primarily through the banking system, were exerting considerable pressure on the price level and the balance of payments. In 1980, economic activity stagnated, and the rate of inflation reached 59 percent. Furthermore, the balance of payments deficit led to a sharp drop in international reserves, while external debt arrears accumulated.

In mid-1981, the Somali authorities adopted a major adjustment program, supported by a one-year stand-by arrangement from the Fund, designed to promote economic growth while curtailing the expansion in domestic aggregate demand. On the supply side, the key measures included a devaluation of the Somali shilling by 50 percent in foreign currency terms for most foreign exchange transactions (the main exception being imports of specified essential goods), the liberalization of private sector imports through official channels, increases in the producer prices of most agricultural products, closures and reassessments of public enterprises, and the strengthening of development planning. On the demand side, fiscal and monetary policies were significantly tightened, with the interest rate structure revised upward. The overall government deficit was narrowed in 1981 to 30 percent of expenditure from 39 percent in 1980. Growth of net credit to the Government from the banking system was sharply reduced, while credit to the nongovernment sector was allowed to expand faster than in the previous year in order to promote private sector economic activity. Consequently, in 1981, the rate of overall domestic credit expansion was only about half the 1980 rate.

These measures, together with favorable weather conditions that led to increased agricultural production, resulted in the marked improvement in the performance of the Somali economy. Although Somalia has no official national income accounts data, Fund staff estimates show that the growth of economic activity accelerated sharply in 1981, reaching about 5 percent. During the second half of 1981, prices started to decline, with the result that, notwithstanding a high rate of inflation in the first half of the year, the annual rate of inflation for 1981 fell to 44 percent. Simultaneously, the external sector position improved significantly—the overall balance of payments deficit of $13 million was nearly half that recorded in 1980 and almost one tenth of that projected in the program. The Central Bank's international reserves increased, and the country's external payments arrears were reduced to about one third of their end-1980 level.

To consolidate the progress made in 1981, the authorities adopted a new stabilization program in mid-1982, supported by an 18-month stand-by arrangement with the Fund with policies aimed at effecting structural changes to lay the foundation for accelerated adjustment. The objectives included maintenance of the growth momentum of the economy, further reduction in inflation, and attainment of a sustainable external sector position over the medium term.

A variety of measures were taken to stimulate supply: the Somali shilling was further devalued, for instance, and a managed floating exchange rate system was introduced; controls on private sector imports were further eased; and marketing and pricing policies were liberalized.

Supply-oriented policies were reinforced with tight fiscal and monetary policies, including a further increase in interest rates. Budgetary operations were generally kept under strict control, despite the recurrence of a border conflict. The Government reduced its net indebtedness to the banking system, effectively releasing resources to the nongovernment sector. Meanwhile, credit to the private sector grew markedly in both 1982 and 1983, to meet resurgent demand. The expansion in domestic liquidity was reduced in 1982 to almost half the 1981 rate, while in 1983, domestic liquidity is projected to have declined significantly.

Reflecting the policies implemented and continued favorable weather conditions, economic growth is estimated to have almost doubled in 1982. Agricultural production, in particular, benefited from the effects of the devaluation and the liberalization of pricing and marketing policies. The rate of inflation was nearly halved. Moreover, despite an unexpected capital outflow, the overall balance of payments outcome was relatively close to the program target. By the end of 1982, Somalia had eliminated all its outstanding external payments arrears. In 1983, adverse weather conditions and a ban imposed by Saudi Arabia on cattle imports from Africa had a serious impact on the Somali economy. The effects, however, were mitigated by the policies pursued, with the result that the rise in the rate of inflation is estimated to have been limited and the current account deficit of the balance of payments to have been narrowed.

By undertaking a major adjustment effort, Somalia has been able to achieve, within a short span of time, substantial improvement in its economic conditions. The contribution of the measures undertaken since 1981 can be expected to be fully realized over the medium term. In this context, the continued pursuit of appropriate economic and financial measures, the formulation and implementation of an appropriate public investment program, and the availability of external financial assistance at concessional terms will affect critically the medium-term prospects of the Somali economy, in particular with regard to the achievement of a sustainable rate of economic growth under conditions of financial stability. Cognizant of these facts, the Somali authorities have prepared for 1984–86 a program for the rehabilitation and consolidation of the economy, including a public investment program, which was favorably received at a Consultative Group Meeting for Somalia organized by the World Bank and held in Paris in October 1983.

Nur Calika, Economist, East African Division, IMF

in 1982–83. The terms of trade declined sharply, reflecting in part the recession in the industrial countries. The current account deficit climbed from about $10 billion in 1979 to an annual average of about $14 billion in 1980–83. These deficits continued to be financed primarily by foreign borrowing, with the result that total outstanding external debt rose by about 50 percent and reached over 50 percent of GDP. The rising international interest rates contributed to an even steeper rise in the debt-service ratio, which nearly doubled.

The immediate prospects for 1984 indicate that African countries will continue to face sluggish rates of economic growth, a high rate of inflation, and a difficult external sector position. The international economic and financial environment is expected to improve; if it does not, it may compound the difficulties that the African countries will face in carrying out their adjustment efforts. In the African region, foreign grants have essentially remained constant in nominal terms since 1979. Therefore, the trend has been for a significant decline in the real value of foreign grants. There are no indications that this trend is likely to be reversed in the foreseeable future. Further, net foreign capital inflows in the African region have remained virtually constant in nominal terms since 1978, implying also a severe real reduction. The recent developments in international capital markets have increased the sensitivity of commercial bankers to the possible risks involved in lending to the non-oil developing countries. As a result, commercial bank lending to developing countries in general is expected to be considerably tighter during the coming years. Furthermore, concessional foreign loans are likely to be constrained by the recent developments in the external position of major oil exporting countries. Thus, both in terms of commercial borrowing and foreign aid, the African countries are likely to face greater constraints in the coming years.

Against this background, the need for adopting appropriate adjustment measures becomes even more urgent and underscores the fact that the adjustment process cannot be viewed as a temporary facet that moves a country from a disequilibrium to an equilibrium position. As both domestic and external economic conditions change, domestic policies have to be readapted continuously to maintain the economy as close as possible to a position of financial stability. The Fund can play an important role in assisting the African countries in two main ways. First, it can provide considerable assistance in the area of policy formulation to contribute to improved financial management. Fund programs generally contain an integrated set of policies that, by reestablishing domestic stability and external financial viability, can contribute to the attainment of a sustainable growth path. Second, the Fund can contribute directly and indirectly to the provision of the necessary external financing to ease the burden of adjustment. Under stand-by or extended arrangements, countries have access to Fund resources. More important, the Fund can play a catalytic role, by working closely with the commercial financial community, as well as with donor governments, to foster an integrated and coordinated effort to secure necessary additional financing. The integrity of Fund conditionality provides the necessary assurance to the international financial community to participate in such financing. F&D

External shocks and policy responses

Under stress, market-oriented economies fared better than others

Bela Balassa

The author's earlier investigations of the adjustment policies applied by developing countries pursuing different development strategies in response to the external shocks of 1973–78 showed that outward-oriented countries were better able to overcome the effects of these shocks through domestic adjustment. This was achieved even though these countries with their greater reliance on international trade suffered greater external shocks than countries pursuing an inward-oriented development strategy. After a temporary decline following the shock, economic growth accelerated in the first group of countries, while declining in the second. These differences in growth rates reflected the lower incremental capital-output ratios in outward-oriented countries—implying less additional capital was required to increase output—as well as their higher domestic savings ratios as a greater proportion of their national income was saved. These economies also relied less than their inward-looking counterparts on foreign borrowing. The conclusions applied equally well to the newly industrializing as to the less developed countries studied. The analysis also showed that reliance on export promotion in response to external shocks, associated with the application of an outward-oriented development strategy, was highly correlated with the rate of economic growth.

This article is based on a longer study published by the Bank as Report DRD 41. Copies are available from the Bank Research Documentation Center, Room I 8-203, 1818 H St. NW, Washington, DC 20433, USA.

Are these conclusions relevant for sub-Saharan Africa? There, it is argued, economic incentives have limited effects, especially in countries at lower levels of development. In attempting to provide an answer, this article summarizes the findings of a study that examined the relevance of the choice of development strategy for coping with external shocks in the oil importing low- and middle-income countries of sub-Saharan Africa between 1973 and 1978. The low-income countries covered were Benin, Botswana, Ethiopia, Madagascar, Malawi, Mali, Niger, Tanzania, Upper Volta, and Zaïre; middle-income countries included Cameroon, Ghana, Ivory Coast, Kenya, Mauritius, Senegal, Sudan, Togo, and Zambia.

Magnitude of the shocks

These countries were grouped according to two types of classification: the first distinguished between interventionist and market-oriented countries, while the second utilized the threefold classification of etatist, intermediate, and private market economies. The first classification separated those countries that tended to be inward-oriented and interventionist in product, capital, labor, and foreign exchange markets from those that placed greater reliance on the price mechanism and market forces and were more outward-oriented in their trade strategies. (The former comprised Benin, Ethiopia, Ghana, Madagascar, Mali, Senegal, Sudan, Tanzania, Zaïre, and Zambia; the latter included Botswana, Cameroon, Ivory Coast, Kenya, Malawi, Mauritius, Niger, Togo, and Upper Volta.) This distinction seems robust; most observers would agree on the classification of different countries, and shifting marginal cases from one group to another changes the empirical results little. Nevertheless, an alternative classification was made in order to provide a finer distinction among countries in terms of their economic policies, with Kenya, Malawi, Niger, Senegal, Sudan, Togo, and Upper Volta being classified in the intermediate group.

The external shocks experienced by the countries in question included changes in their terms of trade and a slowdown of foreign demand for their exports. The effects of these shocks on the balance of payments were estimated by postulating a situation that would have existed in the absence of external shocks. In turn, the policy responses to these shocks included additional net external financing, export promotion, import substitution, and lowering the rate of economic growth.

The balance of payments effects of policy responses were also estimated by postulating a situation that would have occurred in the absence of external shocks. Additional net external financing was derived as the difference between the actual trade balance and the trade balance that would have been obtained if trends in imports and exports in 1963–73 continued; the effects of export promotion were calculated as increases in exports associated with increases in the countries' export shares in 1971–73; import substitution was defined as savings in imports resulting from a fall in the income elasticity of import demand (the rate of growth of imports divided by that of GNP) in the country concerned; and the effects on imports of changes in GNP growth rates compared with the 1963–73 period were calculated by assuming unchanged income elasticity of import demand in the particular country (Table 1). (The original study contains details regarding estimation methods.)

The estimation procedure is subject to certain qualifications: the policies applied in the period of external shocks may represent a continuation of past policies rather than a response to these shocks; structural changes may limit the validity of the assumption that past relationships would have continued in the absence of external shocks and policy responses to them; and

in sub-Saharan Africa, 1973-78

finally, rather than being the result of conscious decisions, measured import substitution may reflect the effects of foreign exchange shortages, brought about by the deterioration of the terms of trade or export shortfalls in countries with limited capacity to obtain funds abroad. These considerations do not invalidate the method applied, however; the policies followed can be judged according to their relative success in coping with external shocks. The study covered a sufficiently short time span to limit the likelihood of structural changes occurring, and by and large the countries that encountered difficulties in obtaining funds abroad got into this predicament as a result of the misuse of funds borrowed earlier. At any rate, there is no reason to assume that such changes would have introduced a bias in the results.

Table 1
External shocks and policy responses in sub-Saharan Africa, 1973-78

	External shocks (As a percent of GNP, 1974–78)	Additional net external financing (As a percent of the balance of payments effects of external shocks, 1974–78)	Change in export market shares	Import substitution	Import effects of lower GNP growth rates	Debt-service ratio (In percent) 1973	1978
Interventionist							
Middle income	4.9	129	−37	20	−13	11.3	20.2
Low income	5.7	37	−49	65	47	10.5	27.7
Average	5.3	84	−43	42	16	10.9	24.2
Market oriented							
Middle income	1.6	37	46	40	−22	14.4	12.7
Low income	7.9	40	38	29	−8	10.6	10.7
Average	2.6	39	42	35	−15	14.0	12.5
Threefold classification scheme							
Etatist	3.7	111	−71	64	−4	9.0	10.9
Intermediate	7.7	64	−18	24	30	17.5	28.5
Private market	−0.8	−240	345	57	−262	7.9	13.4

Source: World Bank Data Base.

Table 2
Savings ratios, incremental capital-output ratios, and growth rates in sub-Saharan Africa, 1963–79

	1963–73	1973–76	1976–79	1973–79
		Interventionist countries		
Domestic savings ratio	16.8	12.4	8.7	10.1
Foreign savings ratio	0.8	6.6	6.1	6.3
Incremental capital-output ratio	7.3	17.3	8.3	7.8
Rate of growth of GNP	3.1	2.0	1.8	1.9
Growth rate of per capita GNP	0.7	−0.7	−0.8	−0.8
		Market-oriented countries		
Domestic savings ratio	16.3	19.2	22.9	21.5
Foreign savings ratio	2.6	3.9	5.9	5.1
Incremental capital-output ratio	3.9	4.0	4.7	4.4
Rate of growth of GNP	5.2	5.5	6.8	6.2
Growth rate of per capita GNP	2.4	2.5	3.8	3.2

Source: World Bank Data Base.

Adjustment policies

There are some clear-cut differences in the adjustment policies adopted by different groups of oil importing sub-Saharan countries. Interventionist countries experienced considerable losses in export market shares that were not fully offset by import substitution (Table 1). In turn, the favorable effects of export promotion and import substitution reinforced each other in market-oriented countries, offsetting over three fourths of the adverse balance of payments effects of external shocks. These countries were also able to limit their reliance on additional net external financing, while the inflow of foreign capital increased to a considerable extent in interventionist countries, even though their import requirements were reduced through lower rates of growth of GNP.

These conclusions are reinforced if use is made of the threefold classification scheme. Etatist countries not only suffered large losses in export market shares, losses which added significantly to the adverse balance of payments effects of external shocks, but the effects of these losses were also only partially offset by import substitution. With minimal reductions in imports associated with deflationary policies, additional net external financing needed by the etatist group exceeded the adverse balance of payments effects of external shocks in

these countries. Nevertheless, increases in debt servicing were mitigated by the large share of grants in external financing.

Export promotion and import substitution both raise output levels in the short run by increasing the utilization of existing resources but may have different implications for long-term economic growth. In the interventionist countries of sub-Saharan Africa, import substitution occurred behind high protection that involved a cost to the national economy. Meanwhile, export promotion in market-oriented countries was associated with reducing the bias of the incentive system against exports, thereby contributing to resource allocation according to comparative advantage, the exploitation of economies of scale, increased capacity utilization, and technological change in response to the stimulus of competition in world markets.

The differences in the growth performance of market-oriented and interventionist countries shown in Table 2 may be attributed to differences in incremental capital-output ratios and in domestic and foreign savings ratios. The higher growth rates of the market-oriented countries were associated with lower incremental capital-output ratios, representing efficiency in the use of incremental resources, and substantially higher domestic savings ratios, reflecting the success of mobilization efforts.

Differences in incremental capital-output and domestic savings ratios are largely explained by the policies followed. Protectionist policies, aggravated by export taxes, price controls, and the commercial margins of parastatal trading companies, discriminated against exports and against agriculture in interventionist countries. At the same time, on the whole, the extent of discrimination increased during 1973–78.

Interventionist countries also failed to devalue their currencies *pari passu* with inflation during the period under consideration. As a result, their real exchange rates appreciated to a considerable extent, discriminating against both exports and import substitution. The extent of appreciation in real terms was especially pronounced, exceeding one fourth, in Mali, Sudan, and Zaïre. The licensing of private investments and the implementation of high-cost, capital-intensive public projects further reduced the efficiency of resource allocation in interventionist—and, in particular, etatist—countries.

By contrast, greater openness and price flexibility, more realistic exchange rates, and a freer choice of private investments, as well as a smaller number (and a more judicious selection) of public projects, favorably affected the efficiency of resource allocation in market-oriented countries.

Domestic savings ratios are influenced by public as well as by private decisions. By and large, the government budget deficit was greater in interventionist than in market-oriented countries, reducing public savings. In those interventionist countries for which data are available, the ratio of the government budget deficit to GDP ranged from 18 percent in Zaïre to 1 percent in Senegal between 1974 and 1978. The highest deficit in a market-oriented country was 6 percent of GDP in Malawi.

Private savings are also affected by interest rate policy. While, on average, real interest rates were negative in all the countries under consideration, they were most negative in two interventionist countries, Zaïre (−24 percent) and Ghana (−22 percent) and the least so in two market-oriented countries, Malawi (−3 percent) and Upper Volta (−2 percent).

The inflow of foreign savings depends on the availability of funds at concessional terms as well as on the creditworthiness of the country concerned for lending on commercial terms. As noted above, interventionist countries borrowed relatively more abroad than market-oriented countries; they also received a larger proportion of foreign funds at concessional terms. At the same time, two etatist countries, Zaïre and Tanzania, encountered limitations in borrowing at commercial terms owing to a decline in their creditworthiness.

Economic performance

To identify the changes that occurred in conjunction with adjustment policies, comparisons were made between 1963–73 and 1973–79 (Table 2). In interventionist countries growth rates fell as did domestic savings ratios, while incremental capital-output ratios and reliance on foreign capital increased—the extent of deterioration in economic performance being greatest in low-income countries. By contrast, GNP growth rates rose between the two periods in market-oriented countries, with the greatest improvement in low-income countries. In low-income countries, increases in domestic and foreign savings ratios, as well as a decline in incremental capital-output ratios, contributed to this result; in middle-income countries, increases in domestic and foreign saving ratios were only partially offset by a rise in incremental capital-output ratios. Market-oriented countries simultaneously increased their reliance on foreign capital to a much lesser extent than interventionist countries, thus avoiding increases in debt-service ratios that more than doubled between 1973 and 1978 in etatist countries.

These findings are confirmed in the threefold classification scheme. Average rates of economic growth fell in etatist countries that experienced a near-quintupling of incremental capital-output ratios as well as a substantial decline in domestic savings ratios that was only partially offset by increased capital inflow. At the same time, average GNP growth rates increased in the countries of the intermediate group, which experienced a decline in incremental capital-output and domestic savings ratios that was more than offset by the increased inflow of foreign capital. Finally, private market economies increased their average rates of economic growth, as increases in domestic savings ratios more than offset a rise in incremental capital-output ratios and a decline in foreign savings ratios.

Confirmation of other results

The results obtained for oil importing sub-Saharan African countries applying different development strategies conform to the author's earlier findings that outward-oriented countries generally perform better than inward-oriented countries. The conclusion applies to exports, domestic savings, the efficiency of resource use, and the rate of economic growth, although market-oriented countries were helped by the lower external shocks they experienced.

At the same time, in comparing market-oriented sub-Saharan African countries with outward-oriented developing countries and interventionist sub-Saharan African countries with inward-oriented developing countries, it is apparent that incremental capital-output ratios are higher and domestic savings ratios are lower in sub-Saharan Africa, leading to lower GNP growth rates. These conclusions apply even if the comparisons are limited to countries at similar income levels; thus, middle-income countries in sub-Saharan Africa tend to have lower growth rates than less developed countries with similar per capita GNP in other regions. The observed differences may be explained by the fact that public interventions are more prevalent in sub-Saharan Africa than elsewhere in the developing world.

Michele Iannacci for F&D

Bela Balassa
a U.S. citizen, studied at the University of Budapest and at Yale University. He has been Professor of Political Economy at the Johns Hopkins University and Consultant to the World Bank since 1966.

Lessons from East African agriculture

A review of the design of Bank agricultural projects in the region over 1972–82 shows mixed results

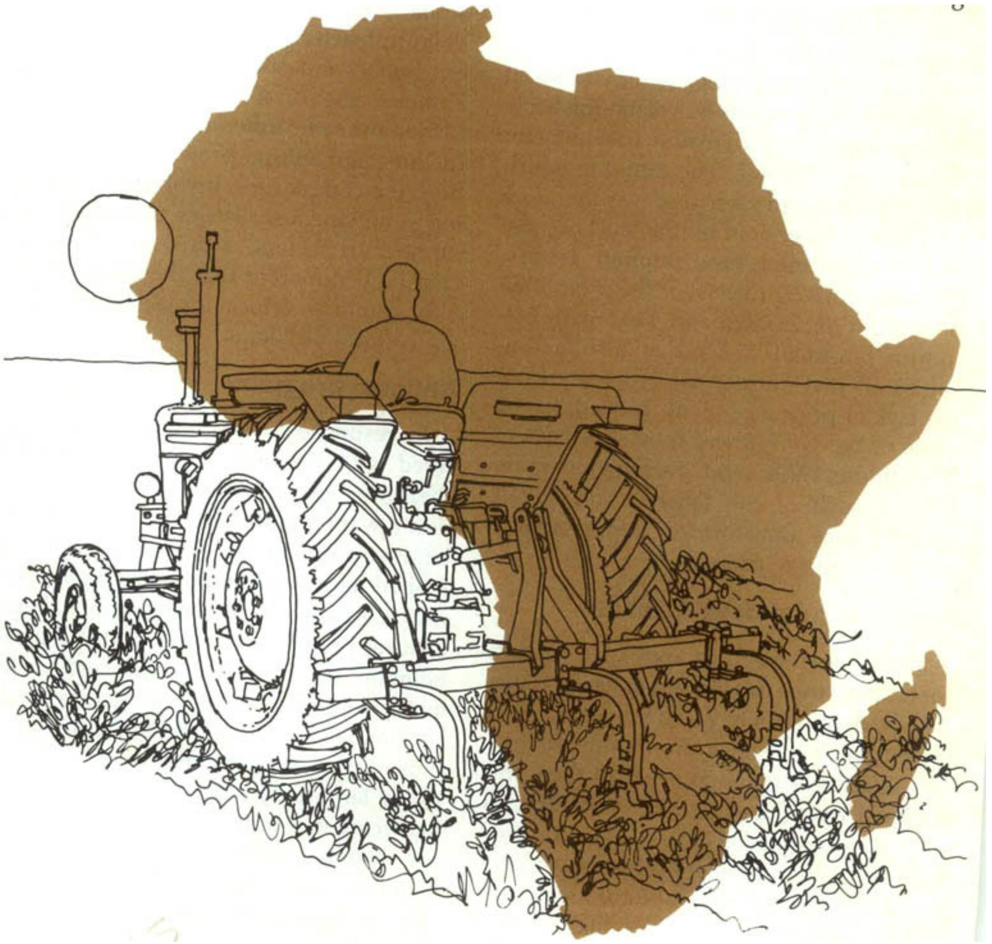
Christopher Walton

The 1982 *World Development Report,* in its review of the critical role played by agriculture in economic development, notes that, in contrast to other parts of the world, agricultural output per capita in sub-Saharan Africa actually declined by 1.4 per cent a year during the 1970s. The critical nature of this state of affairs is exemplified by the fact that agricultural production is for most countries in the subcontinent the largest single contributor to GDP, the major source of export earnings, and the source of most employment. Many reasons have been advanced for this unsatisfactory situation, particularly the difficulties that most African countries had to confront in adjusting to higher oil prices and deteriorating terms of trade. Nonetheless, it is also relevant to examine how donor-supported agricultural projects fared during this period.

The World Bank had an important role as the largest external donor for agricultural projects and programs, devoting about one third of its total lending to the region to this sector during 1972–82. During this period, agriculture and rural development assumed a high priority for most of the countries of the region and for external donors. The Bank's emphasis on lending for rural development was laid by former President Robert McNamara in his Nairobi speech of September 1973. Although this review of the Bank's lending experience focuses solely on the 20 countries that comprise the Bank's East Africa region, empirical evidence indicates that the pattern of lending and project experience was not very different in West Africa, the other sub-Saharan African region.

The Bank's agricultural portfolio in East Africa grew 12 times during this period, with new loans and credits amounting to a total of $1.8 billion for 116 projects and programs in the sector. This compared with total Bank commitments in the region for all sectors of $6 billion for 345 projects during the decade. These figures do not, of course, include financial commitments from other official agencies that joined the Bank in promoting these projects. Over $700 million of cofinancing was associated with Bank agricultural lending. This was significant, not only for the volume of financial transfers but also for the broader influence that Bank project lending exercised over the policies of other donor organizations. Even allowing for inflationary factors and the additional membership of four countries, this large increase in the volume of Bank lending for agriculture over the decade and its sizable share of total commitments demonstrated the importance that the World Bank and its borrowers gave to the sector.

With allowance for some country variations, four different types of projects emerge from the present review. These are (1) the single crop project; (2) the area or regional agricultural and rural development projects; (3) the national agricultural programs; and (4) the structural adjustment and rehabilitation projects. Although these did not follow in a precise sequence, the single crop project was more significant at the beginning than the end of the period, the rural development and national ag-



ricultural programs emerged strongly in lending during the mid-1970s, while the structural adjustment and rehabilitation interventions are a relatively recent response to the difficult macroeconomic conditions that were becoming pervasive toward the end of the period.

Single crop projects

The Bank's first significant involvement in the promotion of crop production (as distinct from investments in agriculture infrastructure such as dams) was made in 1964 for the successful development of a single crop, tea, in Kenya. However, its objectives were simple when compared with projects that were to follow. As a perennial crop, tea was relatively easy to promote because, once planted, it did not require annual decisions on whether to replant or shift to another crop that, in changed conditions, might appear more attractive. When it was in the ground, short of uprooting, tea was there to stay, and after a few years would yield a crop for 50 years or more. Thus at least one uncertainty was removed.

The ecology of the East African countries unfortunately offers few other perennial cash crop opportunities. Thus when, in the 1970s, the single perennial crop approach evolved into projects supporting a single annual cash crop, such as cotton, tobacco, and groundnuts, a number of new difficulties were experienced. Unlike the tree crops, these crops typically were part of a crop rotation and their economic and social value to the farmer was less distinguishable from foodcrops grown mainly or wholly for subsistence purposes. The extent to which they were planted each year was therefore very much dependent on the level of price and other administered support factors. Bank-supported projects for the promotion of tobacco (in Zambia and Tanzania), cotton (in Tanzania), and maize (also in Tanzania) all met substantial problems from the lack of price incentives. Indeed, in the wake of the widespread food shortages of the middle 1970s (and thus higher grain prices), each of the tobacco and cotton projects was transformed into relatively successful maize projects.

Area and rural development

Since the single crop approach, at least for annual crops, was found to have serious disadvantages, there was a marked shift in project design in favor of investments that would address the total needs of the farm, for food crops, and perhaps livestock, as well as cash crops. These regional or area agricultural development projects were designed for limited geographical areas (unlike the single crop projects that usually had a national dimension). Early examples of this group were projects in Malawi, where the Lilongwe Land Development Project was particularly successful, and in Ethiopia; over the course of time, they came to be represented in most countries of the region. While their performance varied considerably, they were generally recognized to have the disadvantages of relatively high cost per beneficiary, more demanding management requirements (usually expatriate staff), and an uneven impact within a country.

The mid-1970s witnessed two parallel changes in project design, each in its different way building upon and interpreting the experiences gained from the area agricultural projects. On the one hand, it was but a short step to extend the scope of the area agricultural projects to include other rural needs, such as water supply, primary education, and health care, and a new type of intervention known as the rural development project emerged. The main difference between the rural and the area agricultural projects was that the rural development project aimed to provide over a limited area an integrated package of infrastructure and social services at levels beyond those that were directly required to support agricultural production. Thus these projects were more broadly aimed at improving living standards in the rural areas. Projects of this kind were prominent in Tanzania (for example, the project in the Kigoma region). This approach also found favor in the Western Sudan and some of the provinces in Zambia. The rural development projects carried the same inherent disadvantages as the area agricultural projects and, in addition, the complexities involved in addressing simultaneously issues presented by a number of sectors. Moreover, it was increasingly apparent that they did not provide a suitable vehicle for tackling national agricultural problems.

National programs

In response to the difficulties encountered with the area agricultural projects, there was also a swing in the other direction toward a more selective and extensive lending program that would address both limited needs and broad policy issues on a national scale. The so-called national agricultural programs evolved out of the recognition that the high unit cost of the intensive area projects would have to be substantially reduced if the benefits of those earlier projects were to be extended to the large proportion of the people who had remained outside their scope. Thus if the regional rural development projects could be characterized as moving horizontally, with successions of projects based on different regions, so the national programs moved vertically, each project in a country separately addressing a major agricultural or support activity on a nationwide basis. The first and relatively successful national program was the Minimum Package Program in Ethiopia (1973), which, starting with a simple expansion of fertilizer use and the rural road network, was over time extended to include other components. Other countries, for example, Malawi, Lesotho, Swaziland, and Kenya, attempted to follow this sequential approach.

Both the area project and the national program approach presented implementation problems; the former because of their weak links with sectoral management and policies at the national level and the latter because they only addressed selected rural needs. Whatever their respective merits, the national programs provided a necessary opportunity for a dialogue between the Bank and member countries to develop understandings on national macroeconomic problems.

Structural adjustment

Bank lending under the most recent concept, the structural adjustment and rehabilitation approach, differs from the earlier projects in that it takes the form of program, not project, loans. These loans finance imports and the related costs of adjusting national economies and are based on the acceptance of substantial policy reforms by the borrower, not necessarily but usually including measures to benefit the agricultural sector. They assist structural adjustment on behalf of the borrower, with fast disbursement of program loans by the donor. Up to the end of fiscal year 1982, only three countries in the region had received structural adjustment loans (Kenya, Malawi, and Mauritius) but the increasing need for restructuring of national economies has led to some program loans specifically directed at the agriculture sectors, of which the Sudan Agricultural Rehabilitation Program (1980) was an important and successful example. This type of lending can encourage domestic reforms, in this case cotton pricing and cost recovery; provide high priority capital goods to revitalize irrigation schemes; and reinforce the effectiveness of existing and planned project lending.

The four different types of projects described above represent more than three quarters of Bank agricultural lending to the region over 1972–82. Other lending went for projects including irrigation, credit, and livestock.

Looking back over the 20 years since the Bank first became directly involved in the promotion of crop production, it is evident

that the process of agricultural development has become vastly more complicated and uncertain. On the one hand, there has been a recognition that the overall development of a country's agricultural economy cannot be achieved by a narrow definition of project lending, whether it be crop- or area-oriented. Agricultural training, extension, crop processing, storage and marketing, research, management system, monitoring, and evaluation are but a few of the legitimate concerns that find some place in most agricultural projects of the early 1980s. On the other hand, experience has shown that the standard of implementation has usually declined as the projects have become more ambitious in their scope and more complex in their design. Moreover, experience has also shown that both sector and project performance depends heavily on the macroenvironment, notably price incentives and dependable support services that can only meaningfully be addressed at the national level. The lessons of experience are legion and often contradictory. Four broad areas merit particular attention in future by donors and borrowers alike.

The technological package

A review of the design of past Bank agriculture projects shows that expected benefits were based on relatively modest improvements in the technical package (usually the introduction of fertilizer) or improved planting techniques, improvements in product quality (for example, through better processing), efficiency savings, the upgrading of infrastructure, or a combination of these factors. Actual experience indicates that the strength of the technological innovations was generally inadequate to overcome institutional weaknesses or to induce changes in traditional on-farm practices. All too frequently, project completion reports reveal a lower than expected stream of production increases and an anticipated economic rate of return that only remained positive because product price increases were higher than costs. The latter condition prevailed in the first part of the 1970s but no longer applies. The response to this situation was often to address on-farm 'social' constraints—important but difficult to influence by any outsiders to the systems—and to improve financial incentives for agricultural production. But regrettably the basic generator of change, significant technological innovation leading to strong financial incentives, has usually been lacking.

An important exception to this (and one that demonstrates its significance) was the large-scale adoption of high-yielding maize varieties in Kenya in the early 1970s, following some 20 years of research. Its rapid and widespread acceptance in Kenya needed little promotion, institutional development, or infrastructure to bring about a major change in the rural areas: in short, the strength of the technological innovation was itself sufficient to overcome other constraints within the broader system.

During the past decade, only one Bank-sponsored project in East Africa was specifically directed at agricultural research (Sudan, 1978). Although many multipurpose projects included a research component and donors other than the Bank made contributions, nonetheless, the research capability in most countries of the region remained woefully inadequate. It is too much to expect a large number of small countries to undertake major research on their own, and there is therefore an important role to be filled by donors, including the Bank with its important contribution to the international agricultural research centers.

A sharper focus

Agricultural development involves the interaction of many types of investments and policies. Thus the Bank's agricultural and rural development projects have typically included a wide range of components. In different ways, both the integrated rural development projects and the national agricultural programs were victims of attempting to do too much, the former by addressing a multiplicity of sectors and the latter by attempting to mix measures designed to address the increasing concerns at the macroeconomic level with the problems faced by specific projects. As a result both approaches, in different ways, ran into trouble. A not unexpected response to this situation were pleas for "simpler" projects (which by the nature of this sector offers limited opportunities) or, in areas of particular uncertainty, for pilot projects (which were not consistent with the demand for rapid improvements in rural incomes).

The more recent and increasingly shared recognition of the importance of the structural adjustment has gone a long way to remove these difficulties and make for more directed agricultural lending in the 1980s. By separating the macropolicy issues in a specially designed series of financial interventions, project designers and implementors can now more closely focus on specific project concerns and a conscious effort more easily be made to direct lending toward more limited objectives within a given time frame.

Thus a logical development of the important start that has been made in this area would be to seek to extend structural adjustment or program lending to all countries with significant agricultural economies. This would imply recognition of the critical importance of a macroeconomic framework in which agriculture can flourish. Although separate, the structural adjustment stream of interventions has to be closely integrated with project lending and indeed, the scale of project lending related to progress under the former simply because the effectiveness of project lending depends on the macroeconomic framework. However, a more conscious effort also needs to be made to limit the scope of individual projects to ensure design quality and appropriate attention to detail.


Robert Townsend for F&D

Christopher Walton
a British subject, educated at Cambridge University, joined the Bank in 1969. He was Division Chief, Agriculture, Eastern African Region from 1972–82, and is now Division Chief, Agriculture for Ghana, Liberia, and Nigeria.

A realistic time frame

The Bank's agricultural projects are typically designed to be fully implemented over four to six years—considered a maximum period for realistic planning consistent with the achievement of a given set of objectives. Such projects can be, and frequently are, followed by subsequent projects, but the principle remains that each project is intended to be complete in itself and that subsequent phases of the same activity address incremental objectives with incremental resources. Thus, it is assumed that over the given life of a project, the resources made available to it—financial, human, and institutional—will be sufficient to produce additional resources to maintain its activities on completion.

Experience over the last ten years has shown that this is far from the case. Financial benefits have typically failed to percolate through to governments or their agencies that are obliged to maintain, for example, a cadre of extension staff or capital investments in infrastructure. Moreover, on project completion governments have become unaccustomed to making adequate budgetary provisions for recurrent costs of maintaining projects and their programs. Likewise, the infusion of a large element of expatriate technical assistance, introduced with the objective of more quickly achieving high production targets, increases the improbability of an orderly transfer of management and technical di-

rection to qualified local people on project completion. Both these factors tend to distance a project from well-grounded local institutional support, which in the broadest sense includes a borrower's political commitment and which is a critical factor in continuity of a development program.

The overwhelming evidence from East Africa suggests the need for follow-up projects, not so much to take an operation to a higher level of activity but more essentially to sustain the earlier achievements. For its part the Bank—and other donors—should be prepared overtly to finance some recurrent costs arising out of projects at their completion against a plan agreed with the borrowers that such further lending would be phased out over an agreed period. For the Bank, such financing could form part of regular follow-up project phases but there would also be a case for incorporating such financing in structural adjustment lending.

The private sector

Most of the Bank's agricultural lending in East Africa over the past decade has been either directly or indirectly in support of the small farmer. This approach conformed not only to the perceived priorities of the time but also to the realities of the local farming structure, which (unlike some other parts of the world) comprises a preponderance of smallholders. This emphasis was not without costs and the absence of an agricultural hierarchy has not only constrained the emergence of private support services in rural areas but also inhibited the development of an effective and vocal constituency in the countryside that could begin to counteract well-established economic groups in the towns. In its absence, the rural cause has had to be espoused by donors and overseas lenders. The rural service problem is well illustrated by the demand for tractor services by small farmers. Their small holdings do not justify sole ownership. In the absence of private entrepreneurs who could provide such services, tractors have been supplied by a succession of government agencies or cooperative societies with a regularity only matching their failures. On both counts, therefore, the emergence of a class of rural entrepreneurs ready to speak up for the interests of the farmer, and to increasingly take on the provision of services in the rural areas, must be seen as an essential element in the transformation of the agriculture sectors.

This article essentially focused on the World Bank's response to its perceptions of the changing demands and constraints of the agricultural economies in East Africa during the past decade with some prescriptions for the next. For the most part, its past lending has represented a concurrence between the Bank and individual borrowers as to what appeared needed at a particular point in time; where such broad agreement has not been reached, its lending program has been more modest. It is evident, however, that a considerable investment in money, time, and intellect has achieved at best mixed results and, overall, less than the situation demanded. The time has therefore come for a new set of understandings that, while building on the considerable body of past experience, can encompass the broad measures of macroeconomic and sector reform necessary for the revitalization of agriculture in the region. Given that determination on the part of both borrowers and lenders, there is no reason why the 1980s should not witness a more successful outcome for these important endeavors. F&D

Progress report on African development

The Bank has issued a Progress Report on its *Accelerated Development in Sub-Saharan Africa: An Agenda for Action* which was published in 1981 (and is generally known as the Africa Report). Two conclusions are highlighted: first, many countries have initiated the policy reforms that are critical for sustained improvement; second, their eventual success depends on higher levels of foreign assistance than have been forthcoming.

The Africa Report was prepared in response to a request from the African Governors at the Bank's Annual Meeting in 1979. It was one of a number of other official reviews of Africa's development needs, and became a major focus of debate on African development problems and policies in governmental and international circles, the academic community, the private sector, and in the media, both in Africa and elsewhere.

The Africa Report addressed the immediate cause of the economic crisis in Africa—falling production rates. It had concluded that if the declining trend of per capita incomes in Africa was to be reversed, major domestic policy reform and institutional change were required to increase the efficiency with which scarce resources were used. Within these reforms, measures that would bring about a marked switch in the incentive structure and in the allocation of government resources toward the agricultural sector were critical, as were the efficiency with which agricultural outputs and inputs were marketed, more appropriate exchange rate policies, and much more attention to research on basic foodcrops. To meet the need for foreign exchange for essential imports and other payments and to support the rapid growth of industry, the Africa Report recommended that existing opportunities for exporting agricultural products be more fully exploited. It also emphasized that for sustained reform to be possible, more external assistance was needed.

The poor economic performance of African countries had not originally been attributed to any major extent to the international trade and financial environment that they had faced. Although during 1979–80, when the Africa Report was being prepared, a major deterioration had already occurred in the global economy, a longer-term review of the 1960s and 1970s had concluded that the problems of development in Africa could not be attributed principally to these factors.

The Progress Report, however, notes that developments since 1980 warrant greater concern with the external economic circumstances confronting African countries; in almost all of them, the externally determined foreign exchange situation has become a major constraint.

Falling export prices, aggravated in some instances by restrictions on market access, have undermined attempts by governments to improve their balance of payments, and this deterioration in their international trading environment is unlikely to be reversed during the 1980s. Even under relatively optimistic assumptions about the speed and magnitude of the economic recovery in the OECD area, the prices of relatively few of the export commodities of African countries are expected to show increases in real terms. All major economic indicators—GNP growth rates, agricultural growth rates, and the level of exports and food inputs, among others—remain matters of extreme concern.

There is now evidence that on a wide set of policy issues many African governments are demonstrating considerably more awareness of policy and institutional weaknesses in the conception and implementation of their development programs. Measures have been taken to improve agricultural prices and the efficiency with which input and output markets operate. Government expenditure programs have reflected both the general shortage of resources and the need to increase the efficiency with which public resources are used.

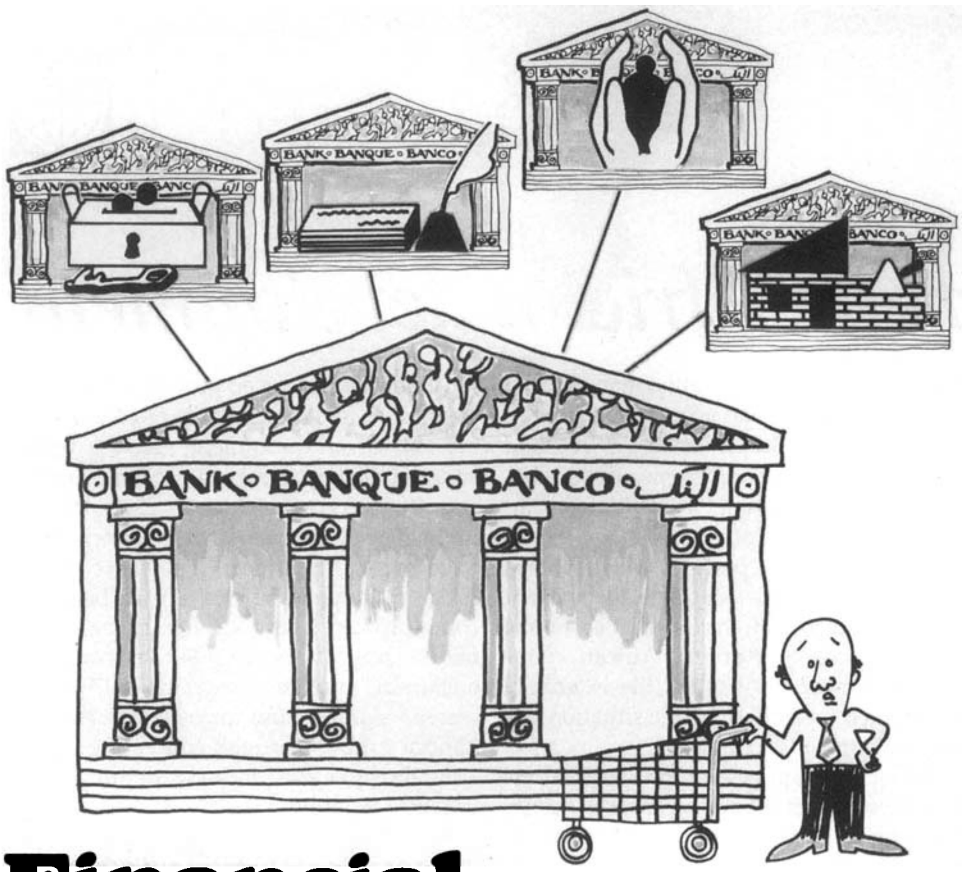
However, these changes represent only a modest beginning; neither the number of countries in which these changes are taking place nor the extent and the speed with which revised programs are being implemented give any cause for complacency.

The Africa Report had emphasized that policy reform was unlikely to be implemented, could not be sustained, and would have limited impact on growth rates in the absence of increasing flows of concessionary aid. Given the difficult global external situation that continues to confront African countries, and which seems likely to continue for several years, these conclusions have become of critical importance. If the programs of policy reform already begun in some African countries are to be maintained, and if the number of countries embarking on such programs is to be increased significantly, major increases in financial support through concessionary assistance from the donor community are urgently required.

According to the Progress Report, in order to provide additional support for policy reform by African governments, the Bank has already increased its country and sector work and has adapted it to be of greater assistance to governments. Moreover the pattern of Bank operations has been modified in major respects to include structural adjustment and other forms of nonproject lending to provide increased support for policy and institutional reform. IDA lending to Africa has also risen—from $954 million in fiscal year 1981 to $1,230 million in fiscal year 1983, the share of sub-Saharan Africa increasing from 27 percent to 37 percent of IDA's worldwide total. However, the extent of the additional financial support is constrained—by the availability of IDA funds and the needs of other recipients—and there also are limits to which IBRD funds can be prudently lent to African countries.

In addition, although individual country experiences have varied, for sub-Saharan Africa as a whole total nominal ODA commitments fell in 1981. Within this total, commitments by DAC members decreased even more sharply. Yet both the need for a markedly higher level of external assistance and the justification in terms of support for programs of major policy reform have increased since 1981 and are rising.

Copies of the Progress Report are available from the Publications Unit of the World Bank. To order see page 48.



Financial supermarkets in the United States

What they are, how they evolved, and what they imply for policy

Charles Collyns and Yusuke Horiguchi

The last several years have seen a remarkable transformation of the financial structure of the United States. Until recently, commercial banks, thrift institutions, and other financial intermediaries played well-defined roles, each offering its customers a limited and specialized array of financial services. Today, these distinctions have to a large extent evaporated, and there are many financial institutions that are able to meet the bulk of the traditional financial needs of consumers in one place; for this reason, they are sometimes referred to as financial supermarkets. By taking advantage of recent advances in banking technology, these financial supermarkets have greatly enhanced the convenience and reduced the costs of financial transactions. In addition, against the background of a rapid liberalization of the regulatory structure, they have been able to offer savers many new financial instruments available in small denominations and bearing interest at rates close to market levels. The resulting financial system is highly competitive and quick to respond to shifting market opportunities, in sharp contrast to the relatively rigid and segmented system from which it emerged.

Early regulation

The roots of the extensive regulatory structure that underlay the previous system may be traced to the financial collapse of the Great Depression. The severity of this collapse was attributed in large part to the unsound banking practices of the time. Fierce competition had led banks to bid up rates of interest to depositors and to seek high-yielding but risky investments. When many of these investments began to fail, a general loss of confidence led depositors in vulnerable banks to attempt to convert deposits to currency. As banks scrambled for liquidity, the crisis spread through the system, while the Federal Reserve failed to ensure the adequacy of bank reserves.

In response to these events, the framework of the financial system was substantially restructured to enhance its underlying stability. Price competition among commercial banks was limited by the Banking Act of 1933, which prohibited interest payments on demand deposits and authorized the Federal Reserve to set ceilings on interest paid on time and savings deposits by member banks of the Federal Reserve System (see glossary). The financial system was effectively segmented by the Glass-Steagall Act, which required banking operations to be clearly separated from activities in the securities market, and the Homeowners Loan Act, which placed restrictions on the loan portfolios of thrift institutions. Revisions of the Federal Reserve Act clarified the responsibilities of the Federal Reserve as the lender of last resort and established closer supervision of banking activities; in addition, insurance of deposits at bank and thrift institutions was established to bolster the confidence of small savers in the security of their deposits. Interstate banking had already been prohibited by the McFadden Act of 1927, while anti-usury laws in some states placed ceilings on interest rates charged on mortgage and other loans.

During the 1950s and 1960s, the financial system performed satisfactorily within this framework, providing a secure flow of funds from saver to borrower. This system was highly compartmentalized, by function as well as by geographic area. Commercial banks channeled funds from depositors needing a ready form of payment and safe store of value to borrowers in the commercial, government, and household sectors; thrift institutions deployed deposits from small savers for use primarily in mortgage lending; security firms and investment banks provided more sophisticated financial services and intermediated between large investors and corporate and government borrowers. The regulatory system remained largely unaltered, except that interest rate ceilings were extended to apply to all commercial banks and to thrift institutions and the diversification of the services offered by banks and their affiliates was restricted by the Bank Company Holding Act of 1956.

Inflation and deregulation

A buildup in inflationary pressures during the late 1960s began to place strains on this system and these intensified with the sharp increase in rates of inflation in the

1970s. Market rates of interest tended to rise in tandem with inflation, often outstripping adjustments in interest ceilings and making the opportunity cost of holding noninterest-bearing reserves an increasing burden. Nondepository institutions, which were not bound by interest rate ceilings, then obtained a substantial competitive advantage and were able to attract business away from commercial banks and thrifts. Money market mutual funds, for example, could issue deposit-like instruments (called shares) that bore market rates of interest and offered a high degree of liquidity. Foreign banks, which were not subject to Federal Reserve regulation and had access to external funding, gained an increasing share of the lending market. Meanwhile, well-established companies often found they could obtain access to funds at a lower cost by selling commercial paper directly to the market rather than by borrowing from a commercial bank.

In response, many commercial banks left the Federal Reserve System in order to avoid the cost of reserve requirements. At the same time, depository institutions sought to bypass regulatory restrictions on interest rates by issuing new types of instruments. One such innovation was the repurchase agreement, under which a bank sold government securities to a customer subject to an agreement for repurchase by the bank at a fixed time and price. Since repurchase agreements were subject neither to interest rate ceilings nor to reserve requirements, banks could thus offer competitive rates to large customers. Another development was that state-chartered thrift institutions in the states of Massachusetts and New Hampshire found a legal means to offer limited interest on checkable accounts; these were called negotiable order of withdrawal (NOW) accounts and competed directly with noninterest-bearing demand deposits.

Throughout the 1970s, there were piecemeal efforts at deregulation aimed at allowing banks and thrift institutions greater flexibility to compete for funds. In 1973, ceilings on interest rates on time deposits of $100,000 or more were completely removed. The authority to offer NOW accounts was gradually extended to all thrift institutions (federally chartered as well as state-chartered) in the New England states, while liquidity for thrift savings deposits was increased by the authorization of automatic or telephone transfers to checking accounts and of direct deposit and withdrawal at automatic teller machines. In the late 1970s, banks and thrifts were authorized to issue 6-month money market certificates and 30-month small-saver certificates; interest ceilings on these certificates were linked to the market yields available on government securities of equivalent maturities. At the same time, U.S. branches of foreign banks were brought within the regulatory framework applied to domestic banks.

Pressure for further change

Despite these reforms, considerable pressure had built up by the end of the 1970s for a more fundamental restructuring of the financial system. Much of this pressure stemmed from the inefficiencies that had resulted from the clash of interest ceilings and high inflation. The efforts banks and thrifts had made to bypass interest ceilings and compete for deposits through the provision of free customer services rather than through interest rates were a major source of inefficiency. Meanwhile, ceilings on loan rates and a shortage of funds had led to credit rationing in the mortgage markets of many states.

The increasingly precarious financial situation of the savings and loans was a second cause for concern. The measures taken to increase the ability of these institutions to compete for funds had not been accompanied by a corresponding relaxation of restrictions on their investment portfolios or liberalization of the rates that they could charge for mortgages. The combination of this asymmetric deregulation with escalating inflation had led to a serious profit squeeze on savings and loans as the cost of their short-term liabilities rose faster than the average return on their primary type of asset, the long-term fixed-rate mortgage.

A third factor behind support for regulatory reform was the growing sentiment that the existing financial system might be inappropriate to macroeconomic policy objectives. The low rate of personal saving experienced in the United States relative to other countries was ascribed, in part, to the poor rewards from holding assets in bank and thrift accounts. At the same time, the Federal Reserve faced increasing difficulty in conducting monetary policy, as its control over money and credit was reduced by dwindling membership in the Federal Reserve System and by the growing importance of new forms of liquidity not subject to reserve requirements.

The political weight of these factors was increased by a shift in the prevailing climate of opinion. Greater emphasis came to be given to the advantages flowing from free market competition as the adverse effects of regulatory rigidities became more evident. It was also felt that the effort to ensure stability of the financial system through interest-rate regulation may have underestimated the stabilizing benefits of deposit insurance and more effective bank supervision. As early as 1971, the President's Commission on Financial Structure and Regulation (the Hunt Commission) had strongly recommended a major liberalization of the financial system. While only a few of the Commission's proposals had been enacted by the late 1970s, the views underlying their recommendations had become widely accepted.

The Depository Institution Deregulation and Monetary Control Act of 1980 followed close to the spirit of the Commission's report. It sought "to enhance the efficiency of financial markets, promote competitive balance among depository institutions, and facilitate the implementation of monetary policy." It was an omnibus act that covered a wide range of regulatory reforms, which included:

(1) The imposition of uniform reserve requirements on transactions balances at all depository institutions, including nonmember banks and thrifts, to be phased in over an eight-year period from September 1980.

(2) The progressive phasing out of interest-rate ceilings over a six-year period and the extension of authority to offer NOW accounts to all depository institutions nationwide from January 1981.

(3) The relaxation of restrictions on the investments of federally chartered thrift institutions to permit such institutions to extend consumer, corporate, and business loans and also to offer credit card services.

(4) The preemption of state-imposed usury ceilings on mortgage, business, and agricultural lending.

Following this Act, the deregulation of interest rates progressed rapidly, and interest rate ceilings have now been eliminated on all deposits except for accounts less than $2,500 maturing within 31 days. Further legislation (the Garn-St. Germain Depository Institutions Act of 1982) authorized a new type of account, the money market deposit account, to help depository institutions compete with money market mutual funds. These accounts offer both liquidity and market-related rates of return (see glossary).

The financial services revolution

The rapid pace of innovation in the financial system over the last decade, the so-called financial services revolution, has led to a situation in which a wide range of institutions vie with each other in offering the customer a great variety of financial products. In contrast to the past, one institution may now supply most, if not all, of its clients' financial requirements. So, for example, a customer may have a checking account and a savings account, borrow to purchase a house or for other purposes,

maintain a credit card, and buy and sell stocks and government securities—all in one institution. Thus, such a financial supermarket offers its customers the traditional virtues of the supermarket grocery—namely, diversity of product and the convenience of one-stop shopping.

Financial institutions, in turn, benefit from increasing their product range, as the overall riskiness of their operations is reduced and their costs are lowered through economies of scale. The overall riskiness of the institution's operations is reduced by diversifying its investment portfolio and its sources of funds. Economies of scale are achieved by aggressive marketing of the expanded product range to attract more business from each customer. The scope for lowering the transactions costs of straightforward banking operations is increased by the dramatic technological innovations of recent years. Applications of new technology include the adoption of electronic fund transfer and information retrieval systems, the introduction of automatic teller machines, and the extension of credit and debit card services.

Over the past 20 years, commercial banks have been fairly successful in defending their dominant position at the liquid end of the financial market; more than half of the short-term assets that comprise M-3 were held in deposits with commercial banks in July 1983 (Table 1). However, there has been a substantial shift in the composition of deposits with commercial banks. While the relative shares of demand and savings deposits have declined steadily, there has been rapid growth in accounts bearing higher rates of interest—in particular, time deposits and, during the last two years or so, NOW accounts, Super-NOW accounts, and money market deposit accounts.

In addition to their deposit-taking functions, commercial banks now offer an increasing variety of customer services. On the lending side, credit may be obtained through a bank in a number of ways: through direct loans to cover particular expenditures, such as commercial credit, mortgage financing, and credit for purchase of consumer durables; through prearranged overdraft facilities; and through the use of a credit card. Other nonbanking but closely related financial services, such as discount brokerage, credit-related life insurance, and the issue of traveler's checks, are also offered by many banks, often through a contractor or affiliate. The permissible range of such activities is regulated by the Federal Reserve Board under the 1970 amendment to the Bank Holding Company Act.

During the 1960s and 1970s, a rising proportion of short-term financial assets was

Table 1
Commercial bank deposits, 1960–83
(In percent of M-3)

	July					
	1960	1965	1970	1975	1980	1983
Demand deposits	36	28	25	19	14	10
Other checkable deposits[1]	—	—	—	—	1	4
Money market accounts	—	—	—	—	—	9
Savings deposits	18	19	15	14	10	6
Small-denomination time deposits	3	5	12	12	14	13
Large-denomination time deposits and repurchase agreements	—	4	5	12	13	12
	57	**56**	**57**	**57**	**52**	**53**

Source: U.S. Federal Reserve Board.
Note: Details may not add to totals due to rounding.
—Indicates zero.
[1] Including NOW and Super-NOW accounts.

Table 2
Thrift deposits, 1960–83
(In percent of M-3)

	July					
	1960	1965	1970	1975	1980	1983
Checkable deposits[1]	—	—	—	—	—	1
Money market accounts	—	—	—	—	—	6
Savings deposits	32	35	25	20	12	7
Small-denomination time deposits	1	1	10	16	23	16
Large-denomination time deposits and repurchase agreements	—	—	—	1	3	4
	33	**36**	**35**	**37**	**38**	**34**

Source: U.S. Federal Reserve Board.
— Indicates zero.
[1] Includes NOW and Super-NOW accounts, share draft balances, and demand deposits.

Table 3
Other financial instruments, 1960–83[1]
(In percent of M-3)

	July					
	1960	1965	1970	1975	1980	1983
Savings bonds	15	11	8	6	4	3
Short-term treasury securities	13	9	9	5	8	9
Commercial paper	2	2	6	4	5	5
Shares in money market mutual funds	—	—	—	—	4	7
Eurodollar deposits[3]	—	—	—	1	3	4
Individual retirement accounts[4]	—	—	—	—	1	3
	30	**22**	**23**	**16**	**24**	**30**

Source: U.S. Federal Reserve Board.
Note: Details may not add to totals due to rounding.
— Indicates zero
[1] With the exception of shares in money market mutual funds and overnight Eurodollar deposits, these investments are not included in M-3.
[2] Both overnight and term.
[3] Held at banks, thrifts, and mutual funds.

held with thrift institutions, although in the last three years their market share has, in fact, slipped (Table 2). As with commercial banks, there has been a shift away from the traditional type of account—in this case, the savings deposit—toward the small-denomination time deposit and, more recently, the money market deposit account. Thrifts now offer almost as wide a product range to the saver as the commercial bank does. They are also able to provide a broader range of lending facilities to customers than had been the case earlier; credit is available for consumer purchase as well as mortgage finance and may also be obtained via an overdraft facility or credit card.

In recent years, money market mutual funds have been the depository institutions' most successful rivals in attracting liquid funds. Holdings of their shares were negligible in 1978 but had risen to 10 percent of M-3 by November 1982, although this proportion has subsequently declined somewhat following the introduction of federally insured money market deposit accounts and Super-NOWs (Table 3). In response, mutual funds are diversifying the range of customer services and investor opportunities they provide, developing high yield and tax-free security investments with similar degrees of liquidity as their money market funds.

A concurrent development has been the formation of financial conglomerates, which combine many individual financial institutions, often including a bank, thrift, or mutual fund. The restrictions of the Glass-Steagall Act and subsequent legislation can be sidestepped provided that the deposit-taking institution involved in the conglomerate does not itself make commercial loans. Conglomerates are able to offer the consumer a package of brokerage and banking services and may take full advantage of the greater scale and geographical spread that their nonbanking connections make possible. Typically, the package would provide a customer with cash management facilities for ready transfer between stock, bond, and money market investments, together with the liquidity provided by a credit or debit card and access to a checkable account. Transactions needs may be met through a "sweep account," an arrangement by which funds are moved automatically as required between transactions balances and investment accounts. The conglomerate may also offer a wide range of other specialized services, such as insurance brokerage, real estate and tax shelter sales, and financial advice.

Thus, commercial banks, thrifts, mutual funds, and financial conglomerates are evolving into institutions that seek to meet most, if not all, of a consumer's needs for financial services in one place. It seems likely that, in such an emerging business environment, the financial institutions that do not follow such a path would only survive by meeting very particular needs for their clients. There would still be a niche for financial "boutiques" offering highly specialized brokerage, insurance, foreign exchange, advisory, and other services; similarly, "community" banks and thrifts could continue to prosper by providing personal service for localized geographic areas or consumer groups.

Problems for policy

Rapid institutional change inevitably raises policy problems, and recent financial innovations have proven no exception to

Glossary

A ***bank*** is defined for regulatory purposes as an institution that accepts demand deposits and makes commercial loans. In December 1983, the Federal Reserve acted to broaden the legal definition of a bank by classifying NOW accounts as demand deposits and by including the purchase of commercial paper, certificates of deposit, and bankers' acceptances in the definition of commercial lending.

The Federal Reserve System is the central bank of the United States created by the Federal Reserve Act of 1913. It regulates the money supply by influencing reserve availability to member banks, provides the central clearing mechanism, and carries out other regulatory and operational functions. The System consists of the Board of Governors, 12 Federal Reserve Banks, their 25 branches, and the national and state banks that are members of the System.

M-1 consists of currency, traveler's checks, demand deposits, and other checkable deposits (including NOW and Super-NOW accounts, credit union share draft accounts, and demand deposits at thrift institutions). ***M-2*** consists of M-1 plus overnight repurchase agreements and Eurodollars, money market mutual fund balances (general purpose and broker/dealer), money market deposit accounts, saving accounts, and small time deposits. ***M-3*** consists of M-2 plus large time deposits, term repurchase agreements, and institution-only money market mutual fund balances.

Money market deposit accounts are accounts available at banks and thrifts that are federally insured, have no fixed maturity, and require only a $2,500 average minimum balance to qualify for the payment of unregulated interest rates. Depositors are limited to six transfers per month (three of them by check) but may make unlimited withdrawals in person. These accounts are defined as nontransactions balances for reserve requirement purposes.

Money market mutual funds are companies that issue deposit-like instruments (called shares) to small savers and invest solely in short-term credit instruments. Customers earn market-related interest rates on their accounts and can write checks (usually with the minimum amount of $250) against their share holdings.

Negotiable order of withdrawal (NOW) accounts are interest-bearing checking accounts. Ordinary NOW accounts bear interest at a fixed rate (5 1/4 percent in December 1983). ***Super-NOW accounts*** are NOW accounts with more than $2,500 average balance, whose interest rates are unregulated. Super-NOW accounts are available only to individuals, governmental units, and certain nonprofit organizations.

Thrift institutions include savings and loan associations, credit unions, and mutual savings banks. A ***savings and loan association*** uses the savings of its members in large part to finance long-term mortgage loans. A ***credit union*** is a mutual thrift institution that uses its funds primarily to make personal loans to members. A ***mutual savings bank*** is a banking organization effectively owned by its depositors, whose funds are invested in mortgages and high-grade securities.

Charles Collyns
a U.S. citizen, is an economist in the Western Hemisphere Department. He joined the Fund in 1981 after completing his doctorate at Oxford University.

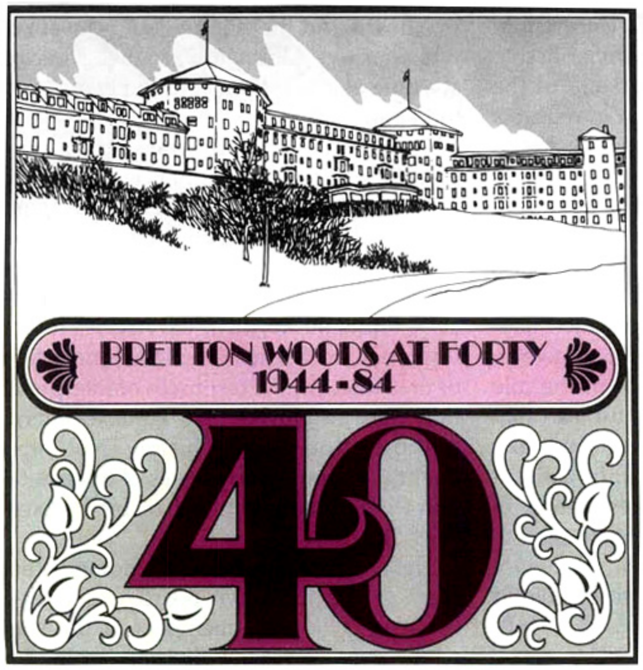
Yusuke Horiguchi
a Japanese citizen, has a PhD from Rice University. He joined the Fund in 1978, after working at the OECD, and is now Assistant Chief of the North American Division in the Western Hemisphere Department.

Photos by Robert Townsend for F&D

this rule. For example, the conduct of monetary policy has been made more difficult by increased uncertainty about the interpretation of the monetary aggregates, M-1 in particular. This problem reflects the proliferation of accounts that can be used for both transactions and savings purposes; these include NOW and Super-NOW accounts, money market deposit accounts, money market mutual funds, and sweep accounts. Reflecting these difficulties, the Federal Reserve has been giving principal weight to broader monetary aggregates (M-2 and M-3) as guides for monetary policy since October 1982. However, although these broader aggregates may appear to be more reliable guides for policy at this time, they are less easy to control than M-1. Direct control over M-2 and M-3 is limited because many of their components are not subject to reserve requirements. In addition, the rapid growth of the proportion of these aggregates that bears interest at unregulated rates has reduced the Federal Reserve's control over them via its influence on market rates of interest.

The advent of supermarket banking has also raised concerns for the stability of individual financial institutions. In particular, doubt has been cast on the viability of those institutions that are unable to compete successfully with the new financial giants. While the process of deregulation enhances the potential opportunities for commercial banks and thrifts, many of these may lack the scale, geographic spread, or entrepreneurial talent to adapt successfully to the new environment. Such institutions would be swallowed by competitors or become insolvent. In assessing such changes, it is important to bear in mind that the proper functioning of the market inevitably involves success and failure in order to allow for fluidity and change. In addition, it should be emphasized that the defenses against local bank failures sparking a general financial crisis are more secure today than they were at the time of the Great Depression. The financial system is stabilized by the protection offered to the small saver by deposit insurance and by the Federal Reserve's commitment to ensure the adequacy of overall bank liquidity.

The challenge facing the financial policymaker today is to strike the appropriate balance between removing unnecessary and inequitable restraints on the market and yet ensuring the safety and soundness of the financial system and safeguarding the efficacy of monetary policy. In this context, various legislative proposals are now being considered that follow the general trend of removing barriers to market forces and restoring the competitive position of banks and thrift institutions relative to nonbanks. Proposals include the further relaxation of restrictions on bank acquisition and mergers and on interstate banking; such legislation would increase the opportunities to take advantage of economies of scale and would reduce the various inequities and anomalies that have resulted from attempts to exploit the various loopholes in existing laws. Also under consideration are the removal of restrictions on the payment of interest on demand deposits and the payment of interest on reserve balances held by depository institutions with the Federal Reserve System. Such actions would reduce incentives toward the development of transaction-type accounts outside the depository system, and thus reinforce the ability of the Federal Reserve to carry out monetary policy efficiently. FD



This year marks the fortieth anniversary of the United Nations Monetary and Financial Conference that was held at Bretton Woods, New Hampshire (United States). This conference, held July 1–22, 1944, led to the creation of the International Monetary Fund and the World Bank. The Final Act embodying the Articles of Agreement of the two institutions was signed on July 22, 1944, and the two institutions came into existence on December 27, 1945.

To commemorate the Bretton Woods conference, the Editor has invited a series of special articles from individuals who were involved with Bretton Woods itself or with the institutions in their early days.

This article presents the personal impressions of Sir Joseph Gold, former General Counsel and Director of the Legal Department of the Fund.

Some impressions of the early Fund

Joseph Gold

The Fund came into existence on December 27, 1945. I joined the staff on October 21, 1946. My remarks will relate largely to the period of the magistracy of Camille Gutt, Ivar Rooth, and Per Jacobsson, the first three Managing Directors. The period came to an end with the death of Per Jacobsson on May 5, 1963.

I was not at Bretton Woods. My astonishment that the delegates had been able to draft the Articles of Agreement in three weeks has never diminished. This feat was without precedent, nor has it been emulated since, in the negotiation of a major multilateral treaty. The Articles gave no evidence of the pressure under which they had been written. On the contrary, Keynes was able to report to the Chancellor of the Exchequer, not without an undertone of surprise, that the final product was "clear and even aesthetic in presentation." What was accomplished at Bretton Woods can be compared with the 8 months of drafting the First Amendment of the Articles and the 20 months of the Second Amendment. "Bretton Woods" has entered the language of finance, as is evident from the tribute paid to the success of the Conference by ministers who express their dissatisfaction with current monetary relations by calling from time to time for "a new Bretton Woods." They must not overlook that Bretton Woods was preceded by discussions among political leaders, officials, and scholars that began as early as 1941 in a world at war, which is yet another cause for wonder.

A newcomer to the staff of the Fund in its first years became aware almost at once of two currents in the atmosphere of the organization. One was the influence of those Executive Directors and members of the staff who had participated in the Conference or in the preparations for it. The intellectual vitality of these people enhanced their influence. It would be ungenerous not to mention the Americans in particular, and Edward M. Bernstein among them. The lucidity of his explanations and the eagerness with which he embarked on them were as remarkable as the foresight with which he seemed always to be on the point of producing from his typewriter the first draft of the very memorandum that was needed at that moment. We nonparticipants were awed by the insiders and happy to accept their tutorship. I have recorded my special indebtedness to one of them in the first volume of *The Fund Agreement in the Courts.*

The other force that charged the air was the exhilaration shared by all in the Fund that they were engaged in a novel and adventurous enterprise. The Fund was going to administer, for the first time in history and after a prolonged and destructive war, a monetary order based on a compact among nations. Members of the staff saw themselves as pioneers and privileged not only for that reason but because they were so few. The sense of partnership was strengthened because it was possible for so small a staff to know almost every colleague. Anyone in the elevator who was not recognizable was assumed to be on the staff of the World Bank.

The spirit of the time attracted outstanding talents to the staff. By early 1948, for example, the Research Department, under the direction of Bernstein, included—without limitation, as lawyers say when defending themselves against the charge of a truncated list—Jorge Del Canto, A.G.B. Fisher, Irving Friedman, Walter Gardner, Earl Hicks, Keith Horsefield, Javier Marquez, Felipe Pazos, J.J. Polak, Ernest Sturc, and Robert Triffin.

Maintenance of a relatively small staff became a tradition that persisted even when recruitment began to increase in response to the growing number of member countries and the expanding activities of the organization. The passage of time, new con-

ditions, and the difficulty of knowing all colleagues in a larger staff made it inevitable that the zeal of earlier years would be replaced by a more sober dedication. The reputation of the staff as an elite corps did not diminish, and has not disappeared to this day, even if for some the adjective elite now has an odious resonance.

The desire to preserve the cohesion of earlier years was a motive for the creation of a Staff Association. When, during the days of Camille Gutt, a few delegates of the staff approached him with trepidation to announce the formation of an association, the tacticians decided that he should be assured early in the interview that the functions of the association would be largely social. The plenipotentiaries were nonplussed by his immediate reaction, delivered with warmth in his typically husky tone: "Good! I have always favored trade unions." Nevertheless, there seemed to be no occasion for activism by the staff in those days: salaries were considered competitive; other terms of service comfortable; and the Fund a kindly employer, with no campaign conducted to make it less so.

Early disappointment

Nevertheless, the early years were not without disappointment, even grave disappointment. It was not produced by a declining sense of mission. On the contrary, unhappiness spread because the mission could not be fulfilled. The United States held the view that reconstruction was the fundamental problem of the time. If industry and agriculture could be restored in devastated countries, there would be no difficulty about exporting the products, and balances of payments would be strengthened. The United States, following the logic of its analysis and dwelling on the financial assistance it was giving through the European Recovery Program, insisted on decisions that impeded the financial activity of the Fund.

Differences about the use of the Fund's resources bred the strongest divisions among members. Notwithstanding the clarity that Keynes thought was a characteristic of the Articles, the provisions dealing with the Fund's financial transactions were not clear enough to prevent controversy about such questions as the choice between those unlovely polysyllables, conditionality and automaticity. Whether or not the Bretton Woods Conference intended to leave these questions for settlement by the Fund itself, or whether each side thought it had succeeded in writing its preference into the Articles, has never been answered authoritatively. The United States succeeded in its advocacy of conditionality when the problems had to be faced by the Executive Board. Uncertainty about the conditions that a member had to meet under this doctrine was one of the deterrents that led to a decline in requests for use of the Fund's resources and, after a time, a total halt in financial activity.

The gloom that this lethargy produced within the Fund was deepened by the speed with which the World Bank's activities began to flourish. In the negotiation of joint activities with the Bank, which usually were no more than administrative in character, the Fund had to accept the role of junior partner. It was painful also that the Fund tended to disappear from the public consciousness. A traveler by taxi had little hope of reaching his destination in Washington if the driver was instructed to proceed to the International Monetary Fund. He had to be directed to the World Bank. Propinquity, at least, was a benefit that the Fund could enjoy.

The absence of financial activity by the Fund may have contributed to the continuing appointment of part-time Executive Directors by some members. The differences of opinion about the character of the Fund that were expressed at Bretton Woods and at the Inaugural Meeting of the Board of Governors at Savannah, Georgia, on March 8–18, 1946, may have been a more important reason. Some members had wanted the Fund's financing to be automatic and they foresaw no need for resident Executive Directors to supervise the Fund's financial activities. Furthermore, nonresident Executive Directors would be more effective in communicating the views of their governments to the Fund on the policies it should follow. The discordant attitudes among members to the service of Executive Directors were only one example of the differences of prenatal days that continued to exist during the formative years of the Fund.

The eventual growth in the Fund's activities led to the disappearance of the nonresident Executive Director. The roster of Executive Directors at all times, however, included men—it was not remarked in those days that there were no women—who had already achieved prominence in international monetary matters or were clearly destined for it. The presence on the Executive Board of these men was a fillip to morale within the Fund. If such names as J.W. Beyen, Guido Carli, Otmar Emminger, Pieter Lieftinck, Wilfried Guth, and Louis Rasminsky come to mind immediately, it is with the realization that the roster could be extended beyond the space available here. It may be of interest to recall that Camille Gutt was elected as an Executive Director but was selected as Managing Director at the first meeting of the Executive Board and that Pierre-Paul Schweitzer was an active Alternate Executive Director at a time of great strain between France and the Fund.

Another consequence of the Fund's early inactivity in providing financial assistance to its members was constant dispute about the jurisdiction of the Fund. The staff, looking to the day when the Fund might realize its potential, often, although not invariably, found authority in the Articles for interpretations that sustained the jurisdiction of the Fund. All the resources of interpretation were employed; text, context, intent, purposes, and drafting history. Not infrequently, even the techniques of interpretation were the subject of debate by the Executive Board.

The preparation of most memoranda that went to the Executive Board was undertaken by groups of members of the staff who served in various divisions of the organization and who were trained in various disciplines. The superiority of collaborative studies was recognized at an early stage. The custom spread to all aspects of the practice of the Fund and did not decline as the structure of the organization became more complex. The effort to reach a joint view provoked much dispute but little rancor among those engaged on an assignment, notwithstanding the confidence that each participant had in his own competence. The names of the collaborators had to appear on the masthead of the memoranda they produced for the Executive Board, but later only the names of those who approved the documents were cited. The Managing Director, as head of the staff, decided that no memoranda went forward without his consent and support. A clear chain of command was established and much virtue was attributed to a short chain.

An international monetary system

A teleological approach in the examination of the Fund's authority was inspired not only by the principle that the Fund must be effective in the pursuit of its purposes but also by the belief that the Articles, and especially the provisions on the par value system, constituted an international monetary system. The Articles were thought to resemble a constitution that governed the area of the Fund's responsibility. Such an instrument provided answers, expressly or implicitly, for all problems, and even as conditions changed. In the early days, there was little mention of so grandiloquent a term as the international monetary system. It became commonplace only in the 1960s when anxiety began to grow that the improvements for which the Fund could claim at least some

credit, such as the convertibility of currencies, the growth of exchange markets, and freedom for capital movements, might be imperiled. The General Arrangements to Borrow, for example, originated in the view within the staff that the position of the United States in the world might be changing. The Arrangements, which entered into force in 1962, referred explicitly to defense of the international monetary system.

In the early decades of the Fund, the idea of amendment of the Articles was not entertained, and even a casual mention of it produced shudders. If amendments were undertaken too frequently or too lightheartedly, the effect would be a loss of respect for the Articles as a constitution. It was feared also that a proposal for the amendment of a provision would open the floodgates to a cataract of proposed amendments.

Many members resisted the assertion of the Fund's authority, particularly in matters involving the Fund's regulatory jurisdiction when the Articles were being clarified or the practice of the Fund developed. This resistance was a reaction to the Fund's parsimony. The decisions on the use of the Fund's resources were adopted at an early stage, although not without strife, largely because there was a special sense of deference to the views of the United States as the member whose currency was likely to be in almost exclusive use in transactions of the Fund. Decisions that would emphasize the obligations of members under the regulatory jurisdiction of the Fund were the subject of more prolonged controversy. Often, these decisions, when reached, would affirm the authority of the Fund, but they would purport to be guidance rather than a final judicial pronouncement or they would contain language that assured members that they would have the benefit of the doubt in the Fund's exercise of its authority. Decisions on par values and restrictions were prominent examples of this tendency. Sometimes, a decision could not be reached at all, as in the case of the Fund's authority over multiple currency practices that are confined to capital transfers.

Deadlock on the use of the Fund's resources was not accepted as the permanent condition of the Fund. Efforts to infuse vitality into the Fund culminated in the decision of February 13, 1952, which was negotiated by Ivar Rooth with the patient and courtly insistence that was characteristic of him. The decision is to this day one of the most remarkable ever adopted by the Fund. The decision clarified the meaning of the temporary use of the Fund's resources by establishing the basic period for use, created the gold tranche, and adumbrated the ideas of the stand-by arrangement and economic programs. I was surprised to receive a letter from Ivar Rooth in April 1971, almost 20 years after the decision, in which he asked me who was responsible for first calling it the "Rooth Plan."

Many in the Fund were perturbed as they observed over the years a growing pluralism in the organization of the international monetary system. They feared that this development would produce a factionalism that could lessen the authority of the Fund as the central organization of the system. Per Jacobsson once said that the Fund need never fear that its opportunities would be limited if it remained aware of its special character. The Fund was not simply the administrator of a code of conduct in matters that had been reserved to the sovereignty of nations in the past. It was also uniquely endowed with substantial resources that it could deploy to encourage observance of the code. The Fund could gain acceptance and cultivate assurance only if it performed effectively as both a regulatory and a financial organization.

Decision by consensus

The patient approach to important decisions in early days became a characteristic, even an ethic, of the Fund. Perhaps the record is held by the decision authorizing the Fund to invest some of its resources, which took nine years of negotiation. Every attempt was made to reach a consensus among Executive Directors on important questions, or at least to reach a situation in which those who could not concur were content to record their objections and forgo further resistance. Voting was avoided. Decisions adopted with the strong arm of those who commanded a majority of the total voting power were considered indecorous and possibly futile. This conviction did not spring into existence full grown, because early delays provoked exasperation and reminders that weighted voting power had been accepted at the recent Bretton Woods Conference and should be exercised if consensus could not be achieved.

The practice of working toward consensus or widespread agreement recognized and promoted the interest of all members in the international monetary system and in the Fund as its central organization. Lewis Namier once formulated a law that dictated the failure of the League of Nations: the impartial were not interested and the interested were not impartial. The Fund has prevailed because all members have been interested.

Perhaps it was easier in those days to involve all members through their Executive Directors. The Managing Director and senior staff were active in the engineering of consent when serious disagreements appeared in the Executive Board. The Executive Directors were fewer, and it was not difficult for one or more members of the staff to make the rounds and report to the Managing Director on the possibilities for negotiating agreement that were open to him. This practice developed after the Executive Board took decisions on January 12, 1948 to demarcate the responsibilities of the Executive Board, the Managing Director, and the staff. These early decisions on the division and interrelation of their functions had become necessary to dispel the unease created by uncertainty about the way the Fund would be operated.

The experience of the early years has left an ineradicable mark on the Fund. Many of the decisions that were taken remain in effect, either as decisions or as amendments of the Articles. Operating procedures worked out at that time continue to be followed. The principle that all members of the Fund are involved in the affairs of the organization through their Executive Directors is still fundamental for success. Continuity and response to change have combined to ensure the vitality of the Fund. The phenomenon is all the more noteworthy in international organization when it is recalled that the purposes of the Fund as stated in Article I have never been changed.

These recollections began by referring to a period in the history of the Fund that ended with the death of Per Jacobsson. The period is distinguishable because, by the time it ended, the Fund, to a considerable degree as the result of his efforts, had achieved maturity and acceptance. But with his passing there departed one of the most colorful persons who have been associated with the Fund. He was impressive in physique and equally powerful in personality, but the beaming eye and the limitless stream of anecdotes put one at ease. His zest for life and labor were prodigious. I remember an occasion when President Kennedy had invited the Ministers and Governors of the Group of Ten to a reception at the White House. Jacobsson, who never shrank from visibility, was distressed because he thought that his invitation had been an afterthought. He summoned me to his room and asked my advice on whether he should attend, and I said that of course he must. When he returned, I was again summoned. He sat in his chair, still discontented, and finally he said, "Do you realize that I was the oldest man there." Another pause, and then he added, "If I am offered a reappointment, I may refuse." I expressed doubt. He waited again, and then he said, "Well, if I accept, they will have to give me two weeks' leave." *Laborare est orare.*

Bretton Woods, 40 years later

40 Milestones

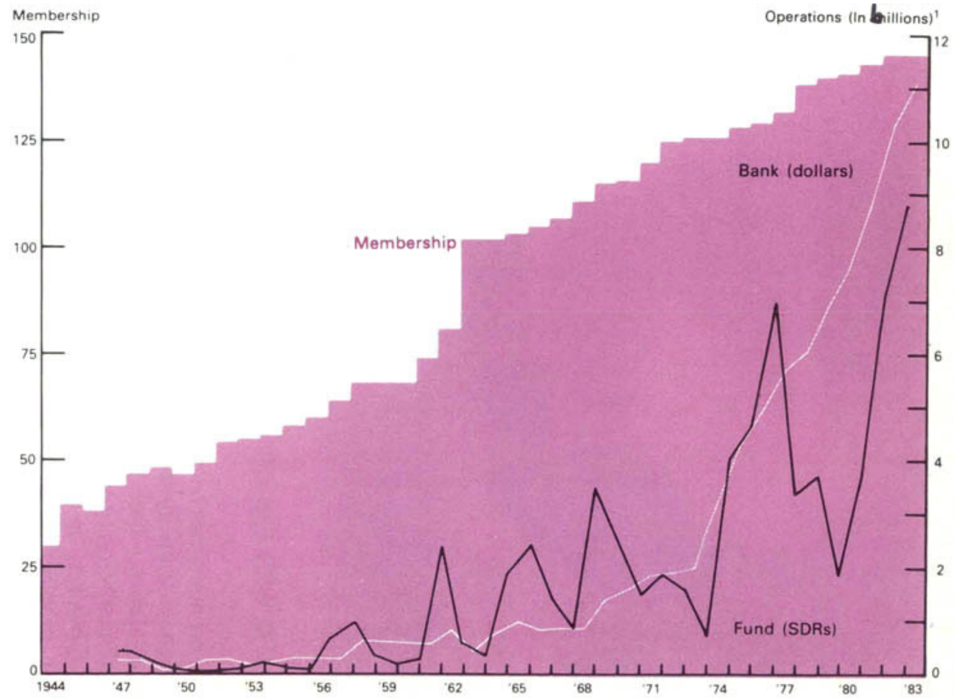
World Bank[1]	Year	Fund
	1944	
Atlantic City meeting; delegates from 16 countries review draft of preliminary proposals for the Bank and the Fund (June 15); Bretton Woods Conference (July 1–22) Final Act embodying the Articles of Agreement of the Bank and the Fund is signed (July 22)		
	1945	
Articles of Agreement of both institutions are signed by a sufficient majority of members (December 27)		
	1946	
Inaugural Meeting of Boards of Governors, at Savannah, Georgia (March) First Annual Meeting of Boards of Governors, in Washington (September)		
Eugene Meyer is appointed first President (June–December 1946); Bank's initial authorized capital is $12 billion		Camille Gutt is appointed Managing Director (June 1946–May 1951); Fund's initial quotas are $7.4 billion
John J. McCloy is appointed President (March 1947–June 1949) First loan, to Crédit National of France (May) First mission, to Poland (June) First bond offer, on U.S. market (July)	1947	First drawing is made on Fund's resources, by France (May)
	1948	
First portfolio sale (January) Technical assistance program begins (June) Eugene R. Black is appointed President (July 1949–December 1962)	1949	
	1950	
	1951	First Quinquennial Review of Quotas completed; no general increase (March) Ivar Rooth is appointed Managing Director (August 1951–August 1956)
	1952	Procedures for annual consultations on exchange restrictions are approved by the Executive Board (January) The "Rooth plan" for a policy on drawings from the Fund is agreed (February) Procedures for stand-by arrangements, drawings, and charges are agreed (October)
Eugene R. Black is reappointed as President (September)	1953	
First dollar bond issue entirely outside United States (September)	1954	
The Economic Development Institute is established (March)	1955	
International Finance Corporation is established, with an authorized capital of $100 million, of which $78 million is initially subscribed (July) Robert L. Garner is appointed President of IFC (July 1956–October 1961)	1956	Second Quinquennial Review of Quotas completed; no general increase (January) Per Jacobsson is appointed Managing Director (December 1956–May 1963)

World Bank[1]	Year	Fund
Robert S. McNamara is reappointed as President of Bank, IFC, and IDA (April)	1973	Johannes Witteveen is appointed Managing Director (September 1973–June 1978) Central rate concept extended to floating rates (November)
	1974	Guidelines for the management of floating rates are established (June) First oil facility is established (June) Extended facility is established (September) Final Report and Outline of Reform of Committee of Twenty is transmitted to Board of Governors at Annual Meetings (September) Interim Committee of the Board of Governors on the International Monetary System (the Interim Committee) is established (October)
Joint Ministerial Committee of the Board of Governors of the World Bank and the International Monetary Fund on the Transfer of Real Resources to Developing Countries (Development Committee) is established (October)		
Fourth Replenishment of IDA becomes effective, providing $4.501 billion (January) Intermediate Financing Facility—to provide development assistance on terms intermediate between those of the Bank and IDA—is approved (July)	1975	GAB is renewed for five years (January) Second oil facility is established (April) Subsidy account is established to subsidize purchases under the oil facility to some members (August)
	1976	Sixth General Review of Quotas is completed and approved by the Executive Board, increasing total to SDR 39 billion (March) Four-year gold sales program is announced (May) Trust Fund is established (May)
The Bank's authorized capital is increased to $34 billion (May) Fifth Replenishment of the IDA becomes effective, providing $7.686 billion (November) IFC Capital Increase is approved, raising capital to $650 million (November)	1977	Principles are approved for the guidance of members with respect to exchange rate policies (April) Supplementary financing facility is established (August)
	1978	Second Amendment of the Articles of Agreement comes into effect (April) Jacques de Larosière is appointed Managing Director (July 1978–present) Seventh General Review of Quotas is completed and approved by the Executive Board, increasing total to SDR 58.6 billion (December)
	1979	Executive Board reviews guidelines on the use of the Fund's general resources in the upper credit tranches (March)
Structural adjustment lending is initiated	1980	GAB is renewed (October)

Bank	Year	Fund
	1957	First gold sales (to the United States) to replenish the Fund's resources (January, May)
	1958	First general increase in quotas becomes effective, increasing the total to $15 billion (September)
Eugene R. Black is reappointed as President (July) Bank capital is increased to $25.3 billion (September)	1959	
International Development Association is established with an initial subscription of $912.7 million (September)	1960	Third Quinquennial Review of Quotas completed; no general increase (December)
Amendment to IFC Articles is announced, to allow it to make equity investments (September) Eugene R. Black is appointed President of IFC (October 1961–December 1962)	1961	Twenty one Fund members, including the principal European countries, accept the obligations of currency convertibility and shift from Article XIV to Article VIII status (February, April) Executive Board decides the Fund's resources can be used for capital transfers (July)
	1962	General Arrangements to Borrow is formed (October)
George D. Woods is appointed President of the Bank, IFC, and IDA (January 1963–March 1968) Bank capital is increased to $26.5 billion (December) The authorized capital of IFC is increased to $110 million (September)	1963	Compensatory financing facility is approved (February) Pierre-Paul Schweitzer is appointed Managing Director (September 1963–August 1973)
First Replenishment of IDA, of $899.7 million	1964	GAB activated for first time to meet drawings by United Kingdom (November)
Articles of Agreement are amended to allow Bank to loan IFC up to four times IFC's unimpaired subscribed capital and surplus (December)	1965	GAB is renewed for four years (October)
Bank capital is increased to $28.9 billion (August) Convention on the Settlement of Investment Disputes enters into force (October)	1966	Fourth Quinquennial Review of Quotas completed; the Executive Board approves general and special increases that raise the total to $21.2 billion (March)
	1967	
Robert S. McNamara is appointed President of the Bank, IFC, and IDA (April 1968–June 1981)	1968	Pierre-Paul Schweitzer is reappointed as Managing Director (September) Conditions on the use of Fund resources are reviewed (September)
Second Replenishment of IDA comes into effect, providing $1.4 billion (July)	1969	Buffer stock financing facility is established (June) First Amendment of the Articles of Agreement enters into force, creating the Special Drawing Account, and the SDR (July)
Authorized capital of World Bank is increased to $32.6 billion (December)	1970	Fifth General Review of Quotas is completed and approved by the Executive Board, increasing total to about SDR 28.9 billion (February); GAB renewed (October)
Consultative Group on International Agricultural Research is founded (May)	1971	Dollar convertibility suspended (August) Smithsonian agreement on exchange rates is concluded (December)
Third Replenishment of IDA comes into effect, providing $2.9 billion (September)	1972	Unit for Fund accounts changed from dollar to SDR (March) Committee on Reform of the International Monetary System and Related Issues (the Committee of Twenty) is established (July)
Bank's authorized capital is increased to $85 billion (January) *Currency pooling system established (July)*		Subsidy account is established to reduce the cost of the supplementary financing facility to low-income members (December)
A.W. Clausen is appointed President of the World Bank, IFC, and IDA (July 1981–present) Sixth Replenishment of IDA becomes effective, providing $12 billion (August) Bank's authorized capital is increased to $86.4 billion (October)	1981	Enlarged access policy is adopted (March) Borrowing agreements with Saudi Arabian Monetary Agency, the BIS, and four central banks are completed (May)
	1982	
	1983	Eighth General Review of Quotas is completed and approved by the Executive Board, increasing total to SDR 90 billion (March) Jacques de Larosière is reappointed as Managing Director (May) GAB is revised and expanded (December)

[1]The Bank's capital stock data, normally expressed in terms of 1944 dollars, has been converted into current dollars on the basis of one 1944 dollar = 1.20635 current dollars. IDA's subscriptions through the Third Replenishment, normally expressed in 1960 dollars, have also been converted at the same current rate.

Bank and Fund membership and operations, 1944–83



Sources: Bank and Fund data.
[1]Bank operations (IBRD loans and IDA credits) on fiscal year basis (ending June 30). Fund operations (purchases) by calendar year.

The realities of economic interdependence

Along with the benefits there are some frustrations, but the alternative would be worse

That the world economy has become much more interdependent, integrated, and internationalized during the past three decades is a generally recognized fact. In recent years, however, in the wake of the worldwide problems of inflation, recession, high energy prices, and debt-servicing difficulties, there has been some questioning of the benefits of this phenomenon and there have even been some suggestions that perhaps greater economic independence, and hence a less integrated world economic system, might be preferable. To consider the feasibility, let alone the desirability, of such a *marche-en-arrière*, it is important to appreciate the degree to which the process of interdependence has proceeded, what its benefits and implications have been, and thus, implicitly, the potential consequences of reverting to a less interdependent international economic system.

As a simple working definition, the concept of economic interdependence may be taken to denote a situation in which (1) what happens in other countries will affect economic performance in an individual country and (2) what an individual country can or wishes to do will to some degree depend on the actions and policies of other countries. It usually means both. Economic interdependence, in short, means that the economic well-being of any one country is affected by the actions and policies of other countries.

But the simplicity of the concept conceals many complexities and shades of meaning. To begin with, interdependence is a matter of degree: no country is totally dependent upon others and none is absolutely isolated. The extent of interdependence (however defined) varies considerably among countries. Similarly, a particular country may be dependent on one other country, a few countries, or the outside world at large, and these dependencies may—indeed often do—change over time. Moreover, beyond the scope of this article are the very important political and military implications of interdependence that interact with and are frequently a function of economic interdependence.

Historical perspective

The high degree of interdependence that characterizes the world economy today—described in greater detail below—may be traced to the policies adopted in the aftermath of World War II to prevent a recurrence of the parlous state of the international economy during the 1930s. That decade had witnessed the progressive disintegration of international economic relations, with the imposition of mounting barriers to international trade and payments, resort to "beggar-thy-neighbor" policies (that is, policies taken at the expense of other countries), and general economic instability and insecurity. On top of these came the numerous restrictions on international payments and exchange necessitated by the war itself.

This article was prepared by the Editorial staff

Thus, by the end of World War II, the world economy was enmeshed in an extensive network of restrictions on international trade and payments. For most countries, trade was limited to essentials, bilateral arrangements in trade and payments were common, exchange restrictions in many forms abounded, and capital movements were under the strictest control. In such circumstances, the economies of nations were to a considerable degree sheltered from each other.

The various arrangements that came into force after the end of World War II, notably the establishment of the Fund, the Bank, and GATT, and associated with this, the launching of what later came to be called the "Liberal International Economic Order," were the key to the process that fostered the progressive internationalization of the world economy. These institutions provided the framework, in an atmosphere of relative economic stability, for a gradual but continuous process of liberalization, at first limited to international trade and payments and, at a later date, extended to capital movements. This process was reinforced by, and in turn facilitated, other developments including the achievement of high levels of employment in industrial countries, much greater factor mobility (capital and labor migration), a major expansion (assisted by rapid technological change) of international transport and communications, the revolutionary advance in electronics, and the growth of transnational corporations.

The impact of these developments on the international economy was direct and

highly visible. The world experienced an era of unprecedented growth, during which the volume of trade increased almost sixfold. This allowed, and was aided by, the recovery of the economies of the European nations and of Japan, as well as rapid development in many other countries.

This so-called golden age of the international economy is assumed by some to have come to an end—or at least to a pause—in 1973, with the formal abandoning of the fixed exchange rate system that had been the centerpiece of the Bretton Woods monetary system, and the quadrupling of energy prices. The ensuing decade has been one of severe economic turbulence for the world economy, characterized by high rates of inflation, substantial balance of payments disequilibria, two major recessions, rapid growth of external indebtedness, high interest rates, and creeping protectionism. Yet, and in spite of the increase in protectionist measures, the world economy has remained highly integrated and indeed, in one respect at least, this very turbulence has led to *greater* integration. This is the rapid growth of international credit and capital markets in the 1970s. It facilitated a major recycling of the surpluses of oil exporting countries following the rise in energy prices, thus permitting countries with serious strains in their balance of payments to obtain financing, while providing an outlet for those countries with large surpluses. The mirror image of these capital movements, however, was the accumulation of very high levels of external debt which, especially in the early 1980s, created major debt-servicing difficulties.

How interdependent are we?

There is no need to resort to elaborate quantitative analysis to demonstrate the growing interdependence of the world economy. A number of basic indicators suffice to show this trend. A key indicator, and one that has traditionally been used as a basic index of interdependence, is the growth of international trade as compared with the growth of GDP. Trade, as a function of national income, grows with it; but if trade grows at a more rapid rate than income, this indicates greater reliance on outside markets for the domestic product as well as on outside sources for domestic consumption and production.

The nominal value of world exports of goods and nonfactor services rose from about $605.3 billion in 1960 to $2,170.5 billion in 1980 (Table 1). When adjusted for inflation, this translated into a 6.7 percent annual growth rate in real terms in the value of world exports. However, during the same period world GDP rose at an annual average rate of 4.4 percent in real terms. Combining these two magnitudes to obtain another measure of economic integration, the ratio of world exports to GDP rose from 12.2 percent in 1960 to 21.8 percent in 1980.

Table 1
World exports and GDP, 1950–80

	Exports (in billions of dollars)	Annual growth rate (in percent)[1]	GDP (in billions of dollars)	Annual growth rate (in percent)[1]
1950	—	—	2,812.0	
				> 4.0[2]
1955	—	—	3,423.0	
				> 4.0[2]
1960	605.3		4,166.6	
		> 7.3		> 5.4
1965	853.6		5,407.6	
		> 8.9		> 5.2
1970	1,298.9		6,948.8	
		> 5.7		> 4.0
1975	1,649.1		8,307.7	
		> 5.5		> 3.8
1980	2,170.5		9,969.9	

Source: World Bank data.
— Indicates data not available.
[1] Least squares growth rate.
[2] End-point growth rate.

While the above demonstrates the growing interdependence of the world economy based on aggregated data, it need not imply increasing dependence for individual countries. The disaggregated data presented in Table 2, however, support the global data in that they show an increase in the number of countries for whom the trade/GDP ratio has increased. Taking all countries, the data show that the number of countries that rank lower in export/GDP ratios (up to 20 percent) has decreased, with a corresponding increase in the number of countries that rank higher (20 to 70 percent). When disaggregated by country groups, the same phenomenon is clearly apparent for industrial countries and oil exporting countries, although it is less pronounced in the case of non-oil developing countries. The data on input/GDP ratios show the same trend, albeit in a less clear-cut way.

Of particular significance to the increasing interdependence of the world economy is the situation of the United States, which remains the largest economy in the world. While three decades ago many countries were already highly dependent on trade, the United States was relatively independent of international trade: exports of goods as a percentage of GDP in the United States in 1952 amounted to only 3 percent. This situation has changed drastically: by 1981 U.S. exports as a percentage of GDP amounted to 8.8 percent.

Financial interdependence

Another, very important, manifestation of growing interdependence concerns financial flows. The progressive liberalization of controls on capital movements and, for the past decade, the regime of flexible exchange rates have given major impetus to the rapid growth of international capital flows. Capital flows comprise many types, including official development assistance and other official flows, direct or portfolio investment, other long- and short-term banking flows, and export credits. Official development assistance grew by nearly 6 percent a year over the past decade, although it has been steadily declining as a share of total flows since the early 1960s. The major part of direct investment is by industrial country corporations in other in-

Table 2
Ratios of merchandise exports to GDP

	Exports as percent of GDP							
	Under 10	10–20	20–30	30–40	40–50	50–60	60–70	70 and over
	In percent of countries							
World								
1960	27.1	34.5	19.8	9.9	2.5	2.5		3.7
1970	18.8	35.9	21.7	3.8	6.6	3.8	1.9	7.5
1980	16.1	25.3	24.0	12.0	8.0	4.0	5.3	5.3
Industrial countries								
1960	20.0	45.0	25.0	10.0				
1970	15.0	35.0	40.0	5.0	5.0			
1980	10.0	20.0	45.0	10.0	10.0	5.0		
Oil exporting countries								
1960	16.6	50.0	16.7	16.7				
1970		10.0	40.0			10.0	10.0	30.0
1980				20.0			40.0	40.0
Non-oil developing countries								
1960	30.9	29.1	18.2	9.1	3.6	3.6		5.5
1970	22.3	39.4	14.5	4.0	7.9	4.0	1.3	6.6
1980	20.0	30.0	18.0	12.0	8.0	4.0	4.0	4.0

Source: International Monetary Fund, *International Financial Statistics Supplement on Trade Statistics*, 1982.

dustrial countries; since 1970, this has almost doubled. Portfolio investment has risen dramatically; it almost doubled between 1975 and 1981 in the industrial world, and rose two and a half times over the same period in the developing countries. In these, it represented about 5 percent of total flows in 1961–63 and accounted for 32 percent in 1981.

On a global basis, long- and short-term capital flows rose almost tenfold between 1975 and 1981. Many of these pass through the international capital markets, an interbank system that has provided a vivid manifestation of increasing global financial interdependence since the early 1970s. In September 1963, the earliest month for which data are available on foreign currency activity in Europe, the BIS quoted the short-term foreign currency assets of its reporting banks (net of redepositing) as $12.4 billion. In 1980, these assets were $575 billion. Euromarket banks have spread beyond Europe to offshore centers in the Caribbean, Latin America, the Near East, and Southeast Asia; to meet different types of demand they have developed innovative and efficient instruments. As restrictions on capital flows have been reduced, the Euromarket has become more integrated with national banking systems.

One of the effects of the greater financial integration has been the large flows of short-term funds across borders in response to interest rate differentials and anticipated exchange rate changes. The advent of flexible exchange rates in 1973 has also expanded the function of the market in two other ways: Euromarkets had long been a source of reserve funds for central banks; this function has grown in importance as the balance of payments positions of many countries have been subject to swings that have increased in size in recent years. Dependence on the markets has also grown as exchange rate changes have increased the risks of commercial transactions and traders increasingly need the protection of forward cover.

The Euromarkets have played a particularly important role since 1973 in recycling the unprecedented balance of payments surpluses resulting from the oil price rises. Between 1973 and 1982, the oil exporters' current account positions and the deficits of the oil importing countries fluctuated widely, with the developing country importers less successful at controlling their deficits than the industrial countries (Table 3).

Part of these deficits was met from official sources: about a third of the aggregate current account deficits of the non-oil developing countries is estimated to be covered by borrowing from official sources in 1983, which had met almost two thirds of the deficits of the low-income group. The major share of aggregate current account financing, however, was provided by private sources, mainly international banks. Between 1974 and 1981, almost 50 percent of the oil exporters' current account surpluses were deposited in and onlent by BIS banks.

One issue that arises out of any discussion of lending in these times is that of debt, some aspects of which have created difficulties (Table 4). The total outstanding long- and short-term debt of non-oil developing countries rose from about 22 percent of their GDP in 1973 to 35 percent in 1983. Within the group, the net oil exporters and the major exporters of manufactures have been the most reliant on commercial bank lending and the low-income countries the least (private financial institutions have only supplied about 12 percent of their total debt since 1979).

Other forms of interdependence

Apart from the growth of trade and financial transactions, the increasing interdependence of the world economy can be gauged from a variety of other indicators reflecting both a widening and a deepening of economic contacts and interchange among nations. Mention may be made of two of these indicators.

The first is labor movements. Although textbooks traditionally have assumed labor to be an immobile factor of production, there has always been international migration of labor in response to international differences in income and employment opportunities. In the last two decades there have been large-scale movements of unskilled, semiskilled, and skilled labor, some legal and some illegal. These movements have taken place not only within the developed and developing countries but also between them. Estimates of migrant workers put their total in the late 1970s at 20 million, of whom 12 million were from developing countries. These immigrant workers were mainly concentrated in certain regions of the world: North America (6 million), Western Europe (5 million), and the Middle East (3 million). Other major destinations included West Africa and South Africa.

Movements of labor result in reverse movements of funds transmitted by workers. Between 1970 and 1980 the flow of worker remittances grew at an average annual rate of almost 26.5 percent. In 1980, remittances to developing countries yielded about $24 billion, up from an estimated $3 billion in 1970. The middle-income oil importing countries—among them the traditional labor exporters of Southern Europe as well as new exporters of migrants to the oil surplus states—earned most from this source. In 1982 it was estimated that remittance receipts by these countries were equivalent to about 34 percent of their current account deficits.

The second indicator concerns the growth of transnational corporations—large companies headquartered in one country but operating in several countries, as employers, purchasers of inputs, and sellers of output. The growing integration of the world economy, in particular the fall in barriers to trade and capital movements, has paved the way for the growth of these corporations. They, in turn, have contributed to economic integration by evolving into large transnational entities, not limited by constraints of domestic market size or costs of domestic inputs, but, on the contrary, availing themselves of the most advantageous conditions in labor, capital, and goods markets. In a sense, therefore, these "world" corporations, for whom national boundaries have limited meaning in economic terms, are good examples of some aspects of an integrated world economy.

Advantages and drawbacks

The benefits of economic integration and interdependence have become amply evident during the past decades. The world economy in the early 1980s, with all its undeniable problems, has an entirely different character to that of the world economy after World War II, and this is, in part, a reflection of economic integration. The enormous expansion of international trade in goods and services and the progressive freeing of capital movements across national borders have promoted a much more efficient utilization of the world's resources, both physical and financial. Moreover, this expansion in international exchange has brought with it a spread of knowledge, technology, and managerial skills—developments that have served to spur economic growth in many developing countries.

Not every country has benefited from economic integration to the same degree nor have benefits been uniform during this entire period. But there can be little doubt that economic growth, on average, has been much greater than would have been possible had the postwar barriers to trade and payments remained in place, or had the world economy reverted to the conditions of the 1930s.

Economic growth is not an end in itself: it allows a higher standard of living and a better quality of life. Again, not all people have benefited nor have those that have benefited done so to an equal degree. But without the economic integration of past

Table 3

Current account positions and private market financing by principal groups of countries, 1973–82

(In billions of dollars)

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
All industrial countries										
Current account position	20	−11	20	1	−2	33	−6	−40	1	−1
Borrowing through private markets	19	27	24	50	59	57	91	116	126	103
Banking	16	22	10	31	39	38	69	96	99	57
Bonds	3	5	14	19	20	19	22	20	27	46
Medium-term credit commitments	12	18	6	9	13	34	24	39	95	52
Oil exporting developing countries										
Current account position	7	68	35	40	30	2	69	114	65	−2
Borrowing through private markets[1]	3	3	8	9	10	15	7	6	3	8
Medium-term credit commitments	3	1	3	3	6	10	8	5	5	9
Non-oil ddeveloping countries										
Current account position	−11	−37	−46	−33	−29	−41	−61	−89	−108	−87
Borrowing through private markets	11	16	16	23	18	29	43	51	54	28
Banking	10	15	15	21	15	25	40	49	51	25
Bonds	1	1	1	2	3	4	3	2	3	3
Medium-term credit commitments	5	9	9	13	13	27	42	32	43	37

Sources: Bank for International Settlements; Organization for Economic Cooperation and Development; International Monetary Fund, *World Economic Outlook*, Occasional Paper No. 21 (May 1983); and Fund staff estimates.

[1] Almost all borrowing was from banks.

decades the substantial improvement in living standards in many countries would not have been possible. It has also been argued that the greater degree of economic interdependence has served to promote a more peaceful world.

Alongside its undisputed advantages, however, economic integration also has other implications, not all of them considered to be positive. To begin with, greater interdependence means *ipso facto* less independence—that is, in our context, a reduced degree of autonomy in domestic policies and actions. The success of economic policy measures taken in one country will, in an interdependent world, to a large extent depend on the policies, actions, and reactions of other countries. To that extent, domestic economic sovereignty is reduced and the effects of policies are more difficult to predict.

By the same token, the economic life of an individual country is more vulnerable to outside developments, both positive and negative. Changes in the level of demand (whether brought about as a result of policy or by natural factors), as well as changes in the conditions of supply, have a greater impact in a country that is more open and outward-looking than in a closed economy. And, to use a current example, decisions by banks in one country can have a far-reaching effect on the financial viability and development prospects of other countries.

The degree of vulnerability to outside economic impulses is not, of course, the same for all countries. The economic size and importance of an individual country is an important determining factor. Just as there are price-makers and price-takers for particular commodities, so in an integrated world economy the smaller or economically

Table 4

Non-oil developing countries: external debt, 1973–83 [1]

(In billions of dollars)

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983
Total outstanding debt of non-oil developing countries	**130.1**	**160.8**	**190.8**	**228.0**	**278.5**	**336.3**	**396.9**	**474.0**	**555.0**	**612.4**	**664.3**
Short-term debt	18.4	22.7	27.3	33.2	42.5	49.7	58.8	85.5	102.2	112.7	92.4
Long-term debt	111.8	138.1	163.5	194.9	235.9	286.6	338.1	388.5	452.8	499.6	571.6
By type of creditor											
Official creditors	51.0	60.1	70.3	82.4	98.7	117.5	133.0	152.9	172.4	193.2	218.7
Private creditors	60.8	77.9	95.1	114.8	137.3	169.1	205.1	235.6	280.4	306.4	353.0
By analytical group											
Net oil exporters	20.4	26.0	34.1	42.4	53.3	61.2	70.5	79.4	96.5	108.1	129.0
Net oil importers	91.4	112.1	129.4	152.5	182.7	225.4	267.6	309.1	356.2	391.5	442.6
Major exporters of manufactures	40.8	51.7	60.9	73.1	85.2	108.1	127.7	145.2	170.6	184.3	212.4
Low-income countries	25.4	29.7	33.2	38.3	46.5	53.1	59.5	67.0	73.0	80.1	90.8
Other net oil importers[2]	25.2	30.6	35.3	41.1	51.0	64.2	80.4	96.9	112.7	127.1	139.4

Sources: World Bank, Debtor Reporting System; and Fund staff estimates and projections, quoted in *World Economic Outlook*, 1983.

[1] For classification of countries in groups shown here, see the introduction to the appendix of *World Economic Outlook*. Excludes data for the People's Republic of China prior to 1977.

[2] Middle-income countries that, in general, export mainly primary commodities.

weaker nations, whether developed or developing, are liable to be more dependent than larger and economically stronger countries. A stronger economic power has relatively greater freedom to change and adapt its economic policies; for instance, the fiscal and monetary policies followed by major industrial countries have a direct and far-reaching impact on the economies of developing countries. Policies that may result in higher interest rates in industrial countries directly increase the burden of debt-servicing for debtor countries, most of which are developing countries. The difficulties, even for major industrial countries, of conducting an independent monetary policy in circumstances characterized by free capital movements and flexible exchange rates have been amply documented in the economic literature.

The implications of greater interdependence may also be looked at from the perspective of the international economic system. A more integrated world economy implies greater mobility in the transmission of economic forces; economic stimuli in one country—such as a higher rate of inflation—spread more quickly and have more direct effects. "Domestic" fiscal and monetary policies in an economically important country are not domestic in an integrated setting: they affect the economies of other countries and therefore the whole economic system.

Economic interdependence can therefore result in greater instability in the international economic system, because shortcomings in domestic policies are more easily and immediately transmitted to other countries. In recent years, this instability has been particularly dramatically demonstrated in the realm of exchange rates, with movements in rates that are not easy to justify by the underlying economic developments.

Thus, economic integration and interdependence have their drawbacks and difficulties, and these must not be underestimated. The instability and disruption that characterize the international economy are a cause for legitimate concern. For instance, the sudden surges in imports that have occurred in many countries, reflecting rapidly changing competitive conditions, have also had a serious impact on these countries. An abrupt dislocation of traditional patterns of production and trade, accompanied by large-scale unemployment, has been experienced by many of the older industrial nations.

And adjustment is a difficult, slow, and often painful process. In particular, as we have seen, the wholesale retrenchment of traditional industries (e.g., steel, textiles) no longer able to compete with imports has resulted, in some countries, in large bodies of unemployed labor, much of which is unskilled or semiskilled, and no longer young. Adjustment, including retraining and relocation, is especially difficult in such circumstances.

These problems and others all too vividly do exist and are brought to the surface by the openness and integration of the international economy. Their resolution is, as mentioned, difficult, costly, and time-consuming. But the solutions do not lie in measures to isolate the economies of individual countries, to reduce integration of the world economy, to achieve greater national economic independence, and to return to a state characterized by trade and payments barriers and other types of restrictions. Given the extent and nature of mutual economic dependence, this would not be a viable solution. But even if it were feasible, any such "relief" would be achieved only at considerable cost—cost in terms of a lower rate of economic growth, a less efficient utilization of resources, a more stagnant international economy, and ultimately lowered standards of living for all. F&D

Excerpts from remarks by Fund Managing Director J. de Larosière to the American Enterprise Institute, December 1983

In a wide-ranging address on a subject related to that of the accompanying article—an address entitled "The domestic economy and the international economy—their interactions," the Managing Director concluded with the following comments on the cooperative policies required in present circumstances:

The need for cooperation is not, by itself, controversial. What is more difficult is to know the kinds of action that will give concrete and beneficial effect to a desire to work together for mutually agreed objectives.... Perhaps the two central issues facing the world economy at the present time [are] the debt crisis facing many heavily indebted developing countries...[and] how to restore sustainable and balanced growth to the world economy at large. Needless to say, the solutions to these two problems are intimately linked....

The first thing I want to say about the debt crisis is that, with appropriate policies, it can be handled and overcome.... The second key point is that the debtor countries themselves must demonstrate that they are taking the necessary steps to regain financial viability, while preserving their capacity to resume economic growth in the medium term.... My third point concerns the need for a proper appreciation by creditors of their role in this process.... The task... is to achieve a smooth transition in which sufficient external financing is available to indebted countries to enable them to scale back their dependence on foreign savings in an orderly fashion, while preserving their ability to invest and grow in the medium term. This process has already proceeded a long way.

This brings me to the issue of how domestic and international economic developments are linked in the process of international recovery. Economic expansion has been proceeding quite strongly in the United States and Canada since around the beginning of this year, but a number of uncertainties surround the sustainability of global recovery. In the first place, recovery is not yet sufficiently well spread geographically. Second, there are a number of factors that threaten to undermine a recovery of business fixed investment which, itself, is central to a sustainable expansion.

First, interest rates remain extremely high in relation to ongoing rates of inflation.... Second, uncertainties about the future course of inflation still remain. The prospective trend of prices beyond the next couple of years depends on policies that are not in all cases clearly established and may yield to political pressures. Third, profitability in manufacturing remains at a low level, particularly in a number of industrial countries.

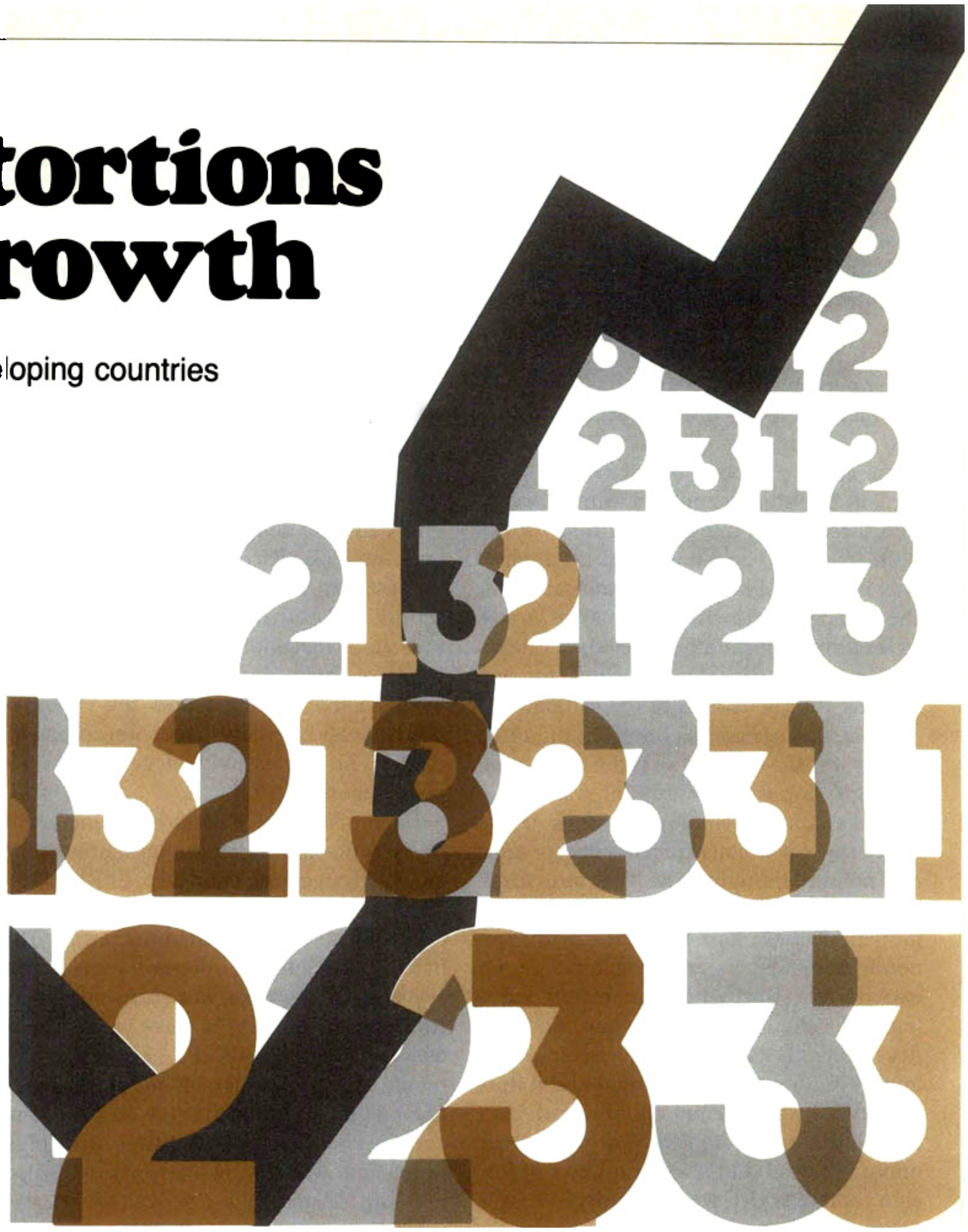
This is not an exhaustive list of the issues facing international policymakers. Nevertheless, it does point to a number of areas in which domestic and international policies interact. The most prominent example is the determination of interest rates in a world where international capital markets are increasingly integrated. Interest rates are influenced both by the current balance between the demand for and supply of investable funds, and the perception of how this balance is likely to evolve in the future. They are also strongly influenced by inflationary expectations—and by the degree of uncertainty that surrounds these expectations....

In an interdependent world, the policies of all countries impinge on the global environment of their trading partners. The institutional framework in which these interactions can be discussed already exists, in embryo, in particular in the surveillance responsibilities of the International Monetary Fund, and in less formal arrangements such as those engaged in by the Summit countries. The need is not for new institutions so much as for the political will to use more intensively those we already have.

Price distortions and growth

A study of the association in developing countries

Ramgopal Agarwala



During the past decades, discussions on development policy have been heavily influenced by the vision of what has been called the "structuralist school" in development economics. This vision underplays the role of markets and prices as tools of resource allocation for economic development. It assumes a benevolent government machinery that can, in principle, ascertain the optimum allocation of resources for "maximizing the national welfare" and has instruments to achieve such an allocation. In determining the optimum allocation, this view emphasizes sectoral balances and self-sufficiency in production rather than prices and costs; for achieving the optimum, it would manage quantities rather than prices, implying either that the latter are not adequately effective tools of allocation or that they have perverse welfare implications. According to this view, distortions that may occur in prices while quantities are manipulated are therefore either innocuous or necessary for achieving social objectives.

During the 1940s and 1950s when the structuralist school flourished, its popularity was understandable. The theory of "market failures" had been developed in the 1930s and 1940s. The newly independent countries, often led by political leaders of considerable stature, were anxious to bring about rapid economic and social modernization, and government activism seemed necessary. The faith in the ability of government to plan and guide the economy was further strengthened in the latter part of the 1950s by the development of econometric models and programming techniques that suggested a rich potential for scientific social engineering. Without the benefit of actual planning experience in a mixed economy, these leaders could only contrast the reality of markets (along with their failures) with the ideal of a planned "golden path," and naturally the ideal seemed more attractive than the reality.

During the 1960s and 1970s, however, the ideal was severely tested and the structuralist vision can no longer be accepted as a tenet of faith. It is necessary to review the reality of the structuralist approach and see how its performance compares with the alternative neoclassical approach, which puts emphasis on the importance of the "right" prices for an efficient allocation of resources.

The results of such an empirical study concentrating on the role of prices in development are reported in this article. The period selected for review was the 1970s and the approach was cross-sectional. The study assessed the variation in price distortions among developing countries during the 1970s to identify any significant relationship between the degree of price distortion and country performance in terms of growth and equity. A review of the experience in the 1970s is particularly useful in learning about the role of prices in managing development; during this period there were several examples of the practical implementation of the competing approaches (following from structuralist and neoclassical visions about prices and markets) that were sustained over a long enough period to provide a basis for some comparative judgment. During this period, too, developing countries experienced several external shocks, and the responsiveness of economies following the alternative systems was tested.

Price distortions

Price distortions exist when the prices of goods and services, as well as capital and labor, depart from "equilibrium" prices.

The more comprehensive study on which this article is based is published by the World Bank, under the same title, as Staff Working Paper Number 575. Copies are $3 and can be ordered from World Bank Publications, P.O. Box 37525, Washington, DC 20013, USA.

Since in practice these are difficult to define, some approximations are commonly used. For example, as a measure of distortions in the pricing of foreign exchange, changes in real effective exchange rates from a base period are generally used, together with the "effective protection" or taxation of traded goods. Similarly, distortions in interest rates are judged by how far they have been negative in real terms rather than by deviation from market clearing prices. Moreover, since the data in many cases pertain to different years and different methodologies are followed for different countries, the quantification of even these approximations is not exact. Therefore, in this study countries were classified into three broad categories of distortion—high, medium, and low—and an attempt was made to obtain average indicators for the decade for growth performance as well as for price distortions. These broad categorizations are considered useful for improving the robustness of the estimates.

Protection of manufacturing. In the 1940s and 1950s, the strategy of industrialization through import substitution was widespread among developing countries. It was supported by various currents of economic and political thought—the basic structuralist vision, an equation of development with industrialization and free trade with economic dependence, and pessimism about exports and fluctuations in export earnings. The then popular two-gap model of development also seemed to assume that import requirements were rigid and it thus provided a rationale not only for trade and exchange controls (to keep imports at their minimum level) but also for inflows of foreign capital, which were considered essential for development.

By the early 1960s, several costs of the import substitution strategy were becoming evident: high capital intensity, excess capacity, low value-added at international prices, underutilization of economies of scale, lack of competitiveness, and the encouragement of "luxury" production behind trade barriers. Several trade studies in the 1970s underlined the importance of these adverse effects and emphasized the "bureaucratic failures" inherent in import substitution. Quantitative restrictions gave industries protection that was far more extreme and discriminatory than the governments imposing them knew or intended. When protection is provided through quantitative restrictions, it creates strong temptations for corruption. Efforts to prevent this lead to a mechanical allocation on the basis of "past shares," which tend to shelter the existing inefficient firms and reduce the speed of adjustment in the economy. On the other hand, an export-oriented strategy limits the use of quantitative restrictions, and the distortions of economic incentives that accompany them, and forces the early recognition and rectification of mistakes that are hidden by an import substitution strategy.

Discussions of trade strategy then led to the theory of effective protection, which has been called "one of the most profound and important recent advances in economics." Despite several conceptual and measurement problems, there has been a spate of estimates of effective protection rates for various countries. As noted by Balassa, protection introduces three forms of distortions to an economy: (1) discrimination among domestic products, (2) discrimination between domestic and foreign products, and (3) discrimination between the domestic and foreign sales of a particular product. Fortunately, Balassa's estimates indicated that not only do these three forms of discrimination go hand in hand, but also that on the whole the extent of discrimination and its dispersion among industries in the individual economies are positively correlated.

On the basis of Balassa's findings, this study concentrated on the measures of the gross effective protection rate (EPR) as indicators of trade-related distortion in the pricing of value-added in manufacturing. The figures available for different years in the 1970s for 31 countries were considered and countries classified into three categories of distortion: high (with EPR of 80 percent or more), low (with EPR of 40 percent or less), and medium (with EPR between 40 percent and 80 percent). The countries with high protection were particularly concentrated in South Asia and East Africa (see chart).

Underpricing of agriculture. The counterpart of protection of industry is taxation of agriculture. This may occur through various instruments, such as direct taxes on output and on exports, compulsory procurement at low prices, or the subsidization of the sale of agricultural products through government channels of marketing and distribution. The rationale for underpricing agriculture is based on four main assumptions: (1) that agricultural production is not very responsive to price changes; (2) that the chief beneficiaries of higher prices would be the larger farmers; (3) that higher prices for food and other wage goods would have adverse effects on low-income consumers; and (4) that rapid growth requires rapid industrialization, which in turn requires a transfer of income from agriculture to industry.

Underpricing agriculture was common in the developing countries in the 1950s. By the 1960s, it was recognized that such underpricing slowed agricultural growth, and that this slowdown, in turn, adversely affected overall growth and equity. On a project level, it was found that inadequate pricing of agricultural products led to poor execution and utilization of agricultural projects, particularly those involving irrigation, extension work, and input distribution. Many countries, including India and Pakistan, switched to policies aimed at reducing discrimination against agriculture, but many developing countries, especially in sub-Saharan Africa, were still underpricing agriculture in the 1970s. In some exceptional cases (for example, the Republic of Korea), there was also distortion in the opposite direction of high protection.

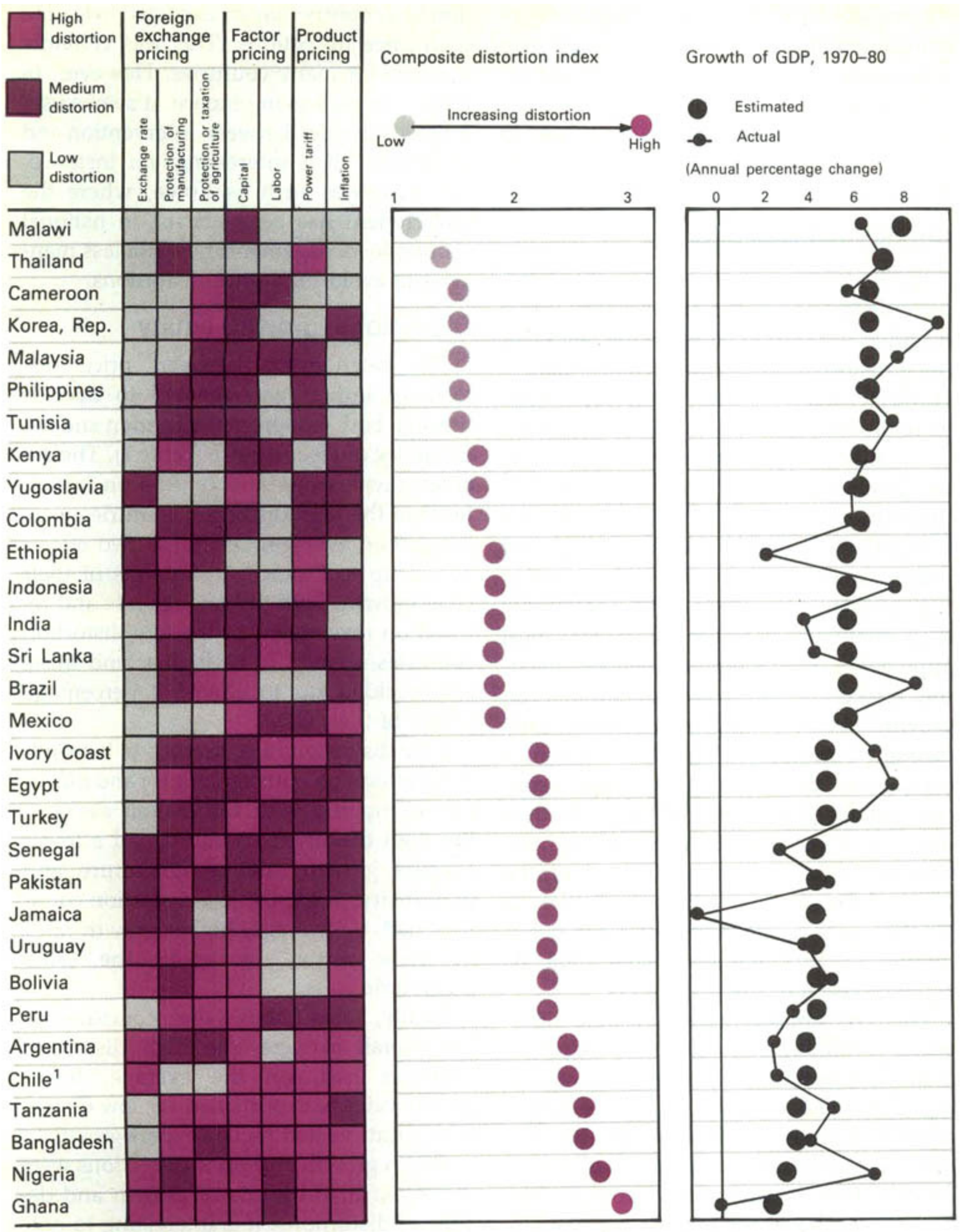
Effective taxation or protection in agriculture has not been studied as thoroughly as it has been in industry, and effective protection coefficients are generally not available. Nominal protection coefficients are more widely available, however; and since, in agriculture, purchased inputs are generally a small proportion of total value added, these are, by and large, satisfactory indicators of the degree of distortion.

On the basis of available information on agriculture, countries were classified into three categories of distortion: high (with absolute value of EPR 30 percent or more), low (with absolute value of EPR 10 percent or less), and medium (with absolute value of EPR 10–30 percent).

Exchange rate. This is, of course, the key variable affecting the relation between domestic and foreign prices. It could be the most effective instrument for simultaneously promoting exports and saving imports in an efficient manner without burdening the administrative system. Unfortunately, the developmental role of the exchange rate has not been adequately emphasized, but rather its suitability for tackling balance of payments problems and sometimes (by and large with disastrous consequences) for controlling inflation. In general, the distortions in exchange rates were the result less of active policy decisions and more of rigid exchange rates in the face of changing underlying conditions.

The problem of distortions due to inflexible effective exchange rates became particularly serious in the 1970s following the breakdown in the Bretton Woods system and the growing inflation in the world economy. In this study, the years before the oil crisis of 1972–73 (when the instability in exchange rate and prices had not yet become endemic) were taken as the base period (with some exceptions, such as Chile), and calculations were made as to the extent that the annual average of real effective exchange rates during 1974–80 deviated from that base. Distortion was regarded as high when the average appre-

Price distortions and growth in the 1970s



Source: World Bank, *World Development Report 1983.*

Note: In this figure, countries are listed in order of increasing degree of distortion in prices. In the first section, the color of the squares indicates the degree of distortion in the principal categories of prices. The middle section is a composite index of price distortion for each country: as a country's distortion index increases, the color of the circle changes from gray to red. In the right hand section, the small circles show the actual annual rate of growth of GDP; the large circles are estimates of GDP growth obtained by a regression relating growth to the distortion index.

[1] Price distortions for the decade were heavily influenced by the policies of the Allende Regime, which ended in late 1973.

ciation was more than 15 percent, low when it was less than 7.5 percent, and medium otherwise.

Cost of credit. Governments in nearly all developing countries in the 1950s believed firmly in low and controlled interest rates and credit rationing. The reasons for the policy ranged from a desire to keep down the costs of servicing public sector debts to one to encourage smaller borrowers and investment.

The policy of low (and relatively stable) nominal interest rates became increasingly untenable as inflation accelerated, particularly in the 1970s. In many countries, nominal interest rates became significantly lower than inflation, and not just temporarily, but on a sustained basis for a decade or more. Negative interest rates penalize and can be expected to discourage savings. Even more clearly, they encourage the public to hold a larger proportion of their savings outside the domestic financial system, and thus reduce financial savings as well as foreign exchange available for domestic investment—thereby encouraging rationing of credit with all its attendant administrative problems. By lowering the real cost of capital to those that have access to it, they permit investments to take place where marginal rates of return are low or even negative. This leads to excessive inventories and excessively high capital intensity, along with overcapacity and slow-moving project implementation; all these serve to lower the average efficiency of investment. The latter also suffers because of the adverse effect of negative real interest rates on the development of financial intermediaries, which can help in allocating savings according to productivity.

During the 1970s, financial savings in several countries were being eroded at an average rate of over 10 percent a year in real terms. In some cases, particularly in Latin America, the real interest rate was lower than −20 percent a year for a decade. Very few countries managed to have positive (small) real interest rates during the 1970s. In this study, countries were classified as belonging to the high distortion category when the decade average of real interest rate was below −5 percent a year, low distortion when it was nonnegative (there was no case of an excessively high positive real interest rate for the ten-year average), and medium otherwise.

Cost of labor. While the cost of credit was distorted primarily because of inflexible interest rate policies, the cost of labor was distorted mainly because of the misplaced interventions of government and pressures from trade unions. Most developing country governments in the 1950s favored the Fabian socialist principles of encouraging trade union activities and promoting minimum wage legislation on the basis of "adequate" income for workers. The fact that organized labor formed a small part of the total labor force in developing countries and the fact that underdevelopment did not permit "adequate" income for all were not heeded by the urban-oriented governments that often mandated the minimum wages. The concern with high wage costs was further muted by the structuralist view that factor proportions were not sensitive to the costs of labor and capital.

In many developing countries real wages increased far beyond the rate of increase in productivity. By the late 1960s, studies and anecdotal evidence showed that capital-labor ratios were, in fact, sensitive to the relative cost of labor and capital. Distortions in labor markets tended to hurt both growth and labor intensity, impeded the growth of employment, and, in particular, contributed to urban unemployment.

Facts on the degree of this distortion are especially hard to collect, since very few developing countries have systematic data

on wages and productivity. As a result, the classification of countries by degree of distortion in this case was based more on qualitative information than on other prices. The basic indicator used was whether real wages in manufacturing rose significantly faster than per capita real income adjusted for changes in external terms of trade. However, any significant evidence of intervention in labor markets by government and/or trade unions was taken into account. Similarly, the longer-term effects of rapid increases in wages in the 1960s were also taken into account.

Pricing of infrastructural services. The pricing of nontradables, particularly infrastructural services, presents difficult problems since they have no border price to serve as a benchmark for pricing. Moreover, since externalities and increasing returns to scale are often important for infrastructure services, markets cannot determine the right prices. The generally accepted criterion is to make the price equal to marginal cost, with the investment level being at the optimum. Here, again, it is difficult to determine whether short-run or long-run cost is a more appropriate basis for pricing and how to measure that cost in practice. Most developing countries tend to underprice infrastructural services, given the externalities. Since these services are generally both capital and energy intensive, however, such a policy leads to an excessive demand for both capital and energy. In many cases, pricing does not cover the average costs of production, and the agencies supplying these services are financially strained and unable to make adequate investments. The usual result is excess demand and rationing, with their attendant problems.

Although the general picture of underpricing of infrastructure services was evident, exact figures on the pricing of individual sectors were not available for the sample countries. The distortions in pricing power utilities were taken as a proxy for distortion in other infrastructure services as well. In this study, countries with an average rate of return in public utilities below 4 percent were regarded as cases of high distortion, those with above 8 percent as low distortion, and others as medium distortion.

Inflation. Particularly when it is high and accelerating, inflation strongly affects the efficiency of resource allocation by creating uncertainty about future prices—both absolute and relative.

It is, however, by no means easy to define high and accelerating inflation. The approach used here was purely statistical. Acceleration was defined as the ratio of the average inflation rate in the 1970s to that in the 1960s, and the cutoff points in terms of level and acceleration of inflation were defined so as to distinguish the top 25 percent and the bottom 25 percent by the degree of distortion. On that basis, distortion was considered high when the inflation rate was greater than 15 percent a year and acceleration greater than four times; low when the inflation rate was less than 15 percent a year *and* acceleration less than four times; and medium in other cases.

Country classification

Analysis showed that for each of the price distortions noted above, there was a negative association between the degree of price distortion and growth performance. However, many of these price distortions were interconnected: some counteracted each other, others were reinforcing. Some composite measure of price distortions was therefore desirable. Because of the complex interaction between distortions in different prices, however, there are major conceptual problems in identifying analytically their relative importance. Three statistical approaches were therefore followed. First, the effects of all seven distortions on growth were analyzed individually through a multiple regression. Second, a composite distortion index was constructed by giving weights to individual distortions in proportion to their correlation coefficient with growth. Third, on the basis of the argument that the initial regression was insufficient basis for determining weights, equal weights were assigned to each of the distortions.

The three approaches led to some differences in ranking of countries by degree of distortion, but the basic conclusion regarding a clear and significant negative association between growth and composite price distortion index was common to all three. As expected, the explanatory power of the first approach was the highest, followed by that of the second and the third. For further analysis and tabular presentation, the composite index was constructed on the basis of simple averages, so as to avoid the risk of exaggerating the association between price distortions and growth. The 31 countries are presented in order of increasing price distortions in the chart.

Michele Iannacci for F&D

Ramgopal Agarwala
an Indian national, is Policy Adviser in the Country Policy Department and was a member of the core team that prepared the World Development Report 1983. *Educated in Calcutta and Manchester, he joined the Bank in 1971.*

A high degree of government intervention in a country may be expected to lead to high price distortions. This was certainly the case for many countries. However, in theory, as well as in practice, it seems useful to distinguish between intervention and distortions. It is interesting, for instance, that countries such as Korea, where the government has been activist in national economic management, nevertheless managed to avoid high price distortions.

Distortions; growth; equity

The relationship between price distortions and growth seemed to operate through both resource mobilization and the efficiency of resource use (Table 1). The average savings rate and returns on investment in the high distortion countries were lower than average, and these two effects added up to 2 percentage points of their GDP growth. Both the savings rate and returns on investment in the low distortion countries seemed to be higher; and these again added up to almost 2 percentage points of their GDP.

Price distortions also seemed to have adverse effects on both agriculture and industry. Compared with the overall average, the high distortion countries had a lower average growth rate in agriculture and in industry, while the low distortion countries had, on average, higher growth rates in these sectors by about the same magnitude.

Finally, Table 1 shows that, compared to the overall average, the high distortion countries had, on the average, lower growth rates of exports and the low distortion countries had higher export growth.

When growth and price distortions were cross-classified by rate of growth and degree of distortions, it is interesting to note that none of the countries with low distortion had a low GDP growth rate; in fact, none had growth rates below 5.5 percent a year. Neither the lack of natural resources (for example, in Korea), nor the early stage of development (for example, in Malawi), nor the socialist system (for example, in Yugoslavia) seemed to be insuperable barriers to policies of right prices (low distortions) and high growth. With one exception, which had obviously special circumstances (namely, Nigeria), none of the countries with high growth rates had high distortions; 60 percent of them had low distortions.

At the opposite end is the experience of the low growth countries: none of them had low distortions, while 80 percent had high distortions. Here, again, neither the

Table 1
Distortion indices and various components of growth during the 1970s
(In percent)

	Distortion index	Annual GDP growth rate	Average domestic saving income ratio	Average return on investment	Annual growth rate of agriculture	Annual growth rate of industry	Annual growth rate of export volume	Percent of income going to bottom 40 percent
Malawi	1.14	6.3	14	25.3	4.1	7.0	5.7	24.5
Thailand	1.43	7.2	21	27.6	4.7	10.0	11.8	15.2
Cameroon	1.57	5.6	18	26.3	3.8	8.6	2.5	—
Korea	1.57	9.5	22	31.1	3.2	15.4	23.0	16.9
Malaysia	1.57	7.8	20	32.6	5.1	9.7	7.4	10.6
Philippines	1.57	6.3	24	23.1	4.9	8.7	7.0	14.2
Tunisia	1.57	7.5	27	31.4	4.9	9.0	4.8	15.0
Kenya	1.71	6.5	19	32.7	5.4	10.2	−1.0	8.9
Yugoslavia	1.71	5.8	27	18.4	2.8	7.1	3.9	18.7
Colombia	1.71	5.9	22	27.4	4.9	4.9	1.9	10.1
Simple group average	**1.56**	**6.8**	**21.4**	**27.6**	**4.4**	**9.1**	**6.7**	**14.9**
Ethiopia	1.86	2.0	8	30.7	0.7	1.4	−1.7	—
Indonesia	1.86	7.6	22	40.1	3.8	11.1	8.7	14.4
India	1.86	3.6	20	15.6	1.9	4.5	3.7	16.2
Sri Lanka	1.86	4.1	13	22.2	2.8	4.0	−2.4	19.2
Brazil	1.86	8.4	22	35.5	4.9	9.3	7.5	7.0
Mexico	1.86	5.2	22	23.4	2.3	6.6	13.4	9.9
Ivory Coast	2.14	6.7	24	25.5	3.4	10.5	4.6	20.0
Egypt	2.14	7.4	12	24.2	2.7	6.8	−0.7	14.1
Turkey	2.14	5.9	17	24.5	3.4	6.6	1.7	11.4
Simple group average	**1.95**	**5.7**	**17.8**	**26.9**	**2.9**	**6.8**	**3.9**	**14.0**
Senegal	2.29	2.5	8	12.8	3.7	3.7	1.2	9.4
Pakistan	2.29	4.7	7	28.1	2.3	5.2	1.2	20.2
Jamaica	2.29	−1.1	16	(0)	0.7	−3.5	−6.82	8.2
Uruguay	2.29	3.5	14	20.9	0.2	5.2	4.8	16.6
Bolivia	2.29	4.8	20	22.7	3.1	4.3	−1.6	13.0
Peru	2.29	3.0	21	21.5	0.0	3.7	3.9	7.0
Argentina	2.43	2.2	22	10.7	2.6	1.8	9.3	14.1
Chile	2.43[1]	2.4	14	15.1	2.3	0.2	10.9	13.4
Tanzania	2.57	4.9	12	23.9	4.9	1.9	−7.3	16.0
Bangladesh	2.57	3.9	2	22.3	2.2	9.5	−1.9	18.2
Nigeria	2.71	6.5	21	23.8	0.8	8.1	2.6	—
Ghana	2.86	−0.1	9	(0)	−1.2	−1.2	−8.4	—
Simple group average	**2.44**	**3.1**	**13.8**	**16.8**	**1.8**	**3.2**	**0.7**	**13.6**
Overall average	**2.01**	**5.0**	**17.4**	**23.2**	**3.0**	**6.1**	**3.6**	**14.2**

Sources: World Bank, *World Development Report 1983*, and World Bank Data Bank.
— Indicates data not available.
[1]Price distortions for the decade were heavily influenced by the policies of the Allende regime, which ended in late 1973.

availability of resources (for example, in Peru or Chile), nor the stage of development (for example, in Argentina) was adequate to prevent low growth when price distortions were high.

The group averages discussed are convenient summaries, but they do not give any idea of the variation within each group, nor do they identify the major deviations from the averages. A simple regression of growth rates on a distortion index showed the latter to have been a statistically highly significant variable for explaining growth in the 31 countries considered, although it accounted for only 34 percent of the variance in growth. For cross-sectional analysis this degree of explanatory power is respectably high, but it does suggest that, as is to be expected, other factors also affect growth. The nature of these other factors is suggested by an examination of the outliers in the chart showing actual growth rates compared with those estimated by the regression equation. Among the countries that had significantly higher growth than estimated are: Nigeria, Korea, Brazil, Egypt, the Ivory Coast, and Indonesia. For Indonesia, Egypt, and Nigeria, oil resources played an important part in explaining this deviation; for Korea and Brazil, political and institutional factors probably contributed to their spectacular success. For the Ivory Coast, it was probably the external assistance—both technical and financial—that contributed to success. Countries that had significantly negative deviation from regression estimates were: Ethiopia, Jamaica, Ghana, and India. For the first three, political factors probably played a key role; for India, bureaucratic rigidities relating to licensing and the control system probably accentuated the losses resulting from the distortions in the pricing system.

In many countries, price distorting policies are justified on the basis of their income distributional impact. For example, it is often argued that low interest rates, high wages, low infrastructure prices, and import restrictions are designed to help the low-income groups. However, studies by Krueger (1978 and 1982) and others have found no evidence of any positive association between protectionist policies and income distribution. Studies of Pakistan have even argued that credit and exchange rate distortions in the 1960s might have increased inequality in income distribution.

Our analysis confirmed these earlier findings. For 27 countries for which figures are available on income distribution, regression analysis showed that the distortion index explained barely 3 percent of the variation in equity, when the latter was measured by the proportion of income going to the poorest 40 percent of the population. And even this low association goes in the opposite direction to that claimed to justify distortions. If anything, high distortion seemed to be associated with lower, not higher, equity.

The analysis of the experience in the 1970s—a period observationally rich for testing the hypothesis about the role of prices in growth—confirms the view that price distortions hurt growth, particularly when they assume high proportions. Countries with low distortions were found to have relatively high growth. There is no evidence that price distortions helped equity. In fact, they may have hurt equity in addition to creating serious administrative problems and corruption.

Needless to say, no statistical analysis by itself can be conclusive in such matters. However, when it is supported by theoretical analysis and earlier detailed country studies, it does constitute a powerful argument—in this case, in favor of avoiding high distortions in prices, trade, and factor markets, as well as in nontraded products.

The findings reported here are a case for "getting the prices right" and should not necessarily be interpreted as an argument for *laissez-faire*. What they mean is that the general case for avoiding price distortions is strong; in particular cases, if price distortion is advocated, the burden of proof lies on those advocating it, either for growth or for equity. **F&D**

The stabilizing role of fiscal policy

Measuring it and evaluating its effects

Sheetal Chand

The government's budget plays an important and pervasive role in the functioning of most economies. Thus, government expenditures are a source of stimulus, while financing them through higher taxes can be contractionary as purchasing power is siphoned away from the taxpayer. Government borrowing from domestic nonbank sources through bond issues to finance outlays can also be contractionary, unless the private sector has excess savings.

In the postwar period, and reflecting the Keynesian revolution in economic thinking, many governments have sought to use the budget to stabilize the economy. Such use, however, has been controversial. Fundamentally, the debate concerns whether or not fiscal policy can smooth out fluctuations in the business cycle and related changes in employment growth, although it also concerns the effects of stabilization efforts on the inflation rate and other policy goals, particularly the balance of payments.

In what follows, certain aspects of a stabilizing fiscal policy are reviewed, with emphasis on how to measure and evaluate its stabilizing effects. Policymakers frequently rely on indicators or summary measures to gauge the stance of a budget, its stimulative effects, and their likely magnitude. But choosing the appropriate indicator is not simple, for the budget's interaction with the economy is complex.

Selecting indicators

The budget interacts with aggregate demand and supply in a typical modern industrial economy through various channels. It can directly affect the market for goods and services through the government's procurement policies. Indirect effects are exerted in several different ways: one important channel is through expectations and, hence, the behavior of individuals. For example, if the authorities run a higher fiscal deficit, individuals may expect higher future taxes to finance the deficit, and may increase current savings—which would then frustrate the direct expansionary effect of fiscal policy. Alternatively, if the higher fiscal deficit is financed by borrowing in the financial markets, interest rates could rise and might crowd out some private expenditure. This again could frustrate the directly stimulative effect of policy. The successful operation of fiscal policy requires that at least some of these indirect reactions be taken into account.

However, in practice it is difficult to take full account of the diverse effects of fiscal policy (distinguishing between their immediate and ultimate outcomes). Some simplifying conventions are needed. One major simplification is to consider only the initial short-run effects of budgets on aggregate demand. A horizon of one year for the analysis is appropriate because it generally coincides with the annual budget cycle in many countries. Nevertheless, it is important to have some idea of the longer-run effects and the likely impact of other policies.

A second convention concerns the degree to which to disaggregate the budget. Not all components have the same impact on the economy: instead of increasing domestic demand, for instance, a budget outlay may result in higher imports that do not stimulate the domestic economy; interest payments on higher debt, too, may be less stimulative than the extension of unemployment benefits, as the recipients of the former are likely to have a higher marginal propensity to save than recipients of the latter. However, typically the details required for a disaggregated analysis are lacking, so attention usually has to be confined to some overall budget concept.

Keynesians and monetarists use different budget concepts. The former stress a balance struck by netting government expenditures against revenue, which is appropriate for a goods market analysis, while monetarists generally prefer a liquidity balance concept that relates to the degree of bank financing of the budget. It is a matter of debate which of the two indicators to employ. Monetarists choose a liquidity balance concept because they believe that even in the short run the money stock and the level of aggregate demand are closely related. Keynesians dispute this connection for the short run and argue instead for a direct identification of the effects of the budget on aggregate demand rather than via a money stock proxy. In practice, for a shorter-run analysis of output and employment effects, a Keynesian budget balance is the preferred choice of many national governments. Keynesians tend to argue that the liquidity definition is more appropriate for assessing the budget's contribution to growth in the money supply and, hence,to the longer-term inflation-generating process.

In any event, the usefulness of either indicator will depend on the stability of the underlying budget composition over the given period. If there are dramatic shifts within it in the relative shares of major components, the assessed effects of a given budget balance may be different from the actual impact. As a precaution, when employing an overall budget concept it is useful to note whether or not there have been or are likely to be any underlying compositional changes. It is also important to specify at the outset the purpose for which the indicator is to be employed, for different indicators are appropriate for different purposes. This is considered further below.

Using indicators

It is a common fallacy to take a selected budget balance and to view both it and its movements as direct indicators of the stance of policy. For a given tax and expenditure structure, however, a different budget balance will result when the economy is booming, for instance, than when it is stagnating. Consequently, it can be erroneous to infer directly from an increase in the budget deficit that fiscal policy has become more stimulative or that it will lead to crowding out of private expenditure; a weakening economic situation could equally well have caused the widening deficit. It is important, therefore, to take note of the underlying state of the economy.

There are essentially two ways to adjust for the effects of the economy on the budget. One involves controlling for fluctuations in the level of economic activity, and is the so-called full employment balance method developed by the Council of Eco-

nomic Advisors in the United States. Here the procedure is to ask what the budget balance would be at an assumed full employment level of the economy. Those elements of the budget, such as revenue or unemployment benefits, that are sensitive to the cycle, will be affected by this estimation. The resulting Full Employment Budget Balance will then be invariant with respect to the given full employment level of income, unless the level of discretionary expenditures or the structure of taxation are modified. Hence, the expansionary implications of different budget structures (fiscal policies) can be ranked by looking at the size of their full employment deficits. The bigger the full employment deficit, the more expansionary the budget is judged to be.

Another way to handle the effect of the business cycle on the budget is first to select a base year budget balance with desirable properties. The latter include those of being appropriately aligned with respect to the corresponding balances of the private and external sectors in a year for which the overall performance of the economy is judged satisfactory. Movements in this budget balance are then computed that are cyclically neutral, using the trend rate of growth in GNP, or direct estimates of potential output, to determine the "neutral" growth in government expenditure, while "neutral" revenue is that which grows equiproportionately with actual GNP. The justification for such criteria is straightforward. A growth in government expenditure that is in step with the enlargement of the productive potential of the economy does not contribute to excessive pressure. However, because revenue responds to actual GNP growth, it should grow in step with GNP for the revenue side of the budget to be neutral in its impact on aggregate demand. Of course, if revenue grows more rapidly, it will be exerting a contractionary effect (fiscal drag) on the economy. It should be noted that the revenue criterion is used in assessing whether or not the revenue response is *nonneutral,* which is not the same as identifying discretionary revenue policy, unless the underlying responsiveness of revenue with respect to GNP growth (the so-called built-in elasticity) is unity.

The next step is to test an actual budget balance against that year's cyclically neutral balance. If the actual budget deficit, say, exceeds the adjudged cyclically neutral deficit, the cyclical effect of the budget is deemed expansionary and conversely. This difference is defined in the box and is referred to there as the cyclical effect of the budget. Such a measure, however, is highly sensitive to the choice of base year balance. A more robust indicator is provided by considering the year-to-year change in the budget indicator described above (i.e., in the CEB in the box). This measure of the fiscal impulse indicates the initial contribution to the annual fluctuation in aggregate demand.

The different techniques described above for adjusting a budget balance focus on real (employment-affecting) fluctuations. However, an observed budget outcome can reflect the operation of several factors. The pursuit of a more expansionary fiscal policy will cause a budget deficit to widen. At the same time this policy may stimulate higher output, domestic price inflation, and a larger volume of imports. If revenue is sensitive to these factors, an improvement in the budget balance could result, although not generally of a magnitude to completely offset the initial increase in the budget deficit. In addition, factors operating independently of the budget may have led to a higher rate of inflation or a deterioration in the terms of trade that also exerted effects on the observed budget outcome. How should such "non-output" related effects, whether or not induced by the budget, be handled in the assessment of fiscal policy?

The preceding question can be answered in different ways which, in turn, can lead to additional adjustments to the budget balance measure. Thus it can be contended that fiscal policy should not be agnostic with regard to domestic inflation and that a normative (acceptable) rate of inflation should form part of the analysis. It might also be argued that any inflation-induced interest rate increase that raises outlays on the public debt should be excluded from the budget balance, as it could give the misleading impression that fiscal policy is more expansionary, when all that has occurred is that private holders of government debt have been compensated for an erosion in the real value of their holdings.

A major drawback with these and other adjustments that have been proposed is that they render the summary measure more complex. Moreover, it is not altogether clear that such adjustments should be rendered to a measure of fiscal policy, given the standard definition of fiscal policy as comprising those transactions that affect the budget balance and thus the growth in the public debt, while assigning responsibility for its composition and valuation to monetary policy. Several implications follow from observing the preceding definition. First, to the extent inflation is regarded as a monetary phenomenon, while the dominant concern of fiscal policy is stabilizing output, a case can be made for separating the two objectives. Second, regarding the treatment of higher inflation-induced interest outlays, it may be prefera-

Budget indicators

In order to obtain a simple indicator of the effect of the budget on the economy (i.e., aggregate demand), first determine a cyclically neutral balance (CNB). $G_o - T_o$, (where G = government expenditures, T = receipts in base year, o) denotes the balance in some base year of satisfactory performance. The CNB for each year is determined by applying the base year revenue to GNP ratio (t_o) to that year's actual output level and the base year expenditure to GNP ratio (g_o) to that year's potential (trend) output level; the difference is the CNB.

Next, the computed CNB is subtracted from the actual budget deficit for that year to determine the so-called cyclical effect of the budget (in real terms): $CEB = G - T - [g_o Y^p - t_o Y]$ with Y representing GNP and the superscript p its potential level. A positive CEB indicates an expansionary budget effect and conversely. This value is zero for the base year.

A simple way of identifying the "structural" or underlying balance component of a particular year's budget is to take the base year balance defined above and to add to it the cyclical effect of the budget (CEB) for that year—see table below for an illustration based on U.S. data. The CEB provides a rough estimate of the amount of additional revenue or reductions in expenditure needed to restore the base year balance. In this case 1978 has been selected as the illustrative base year.

U.S. Federal Government fiscal data, 1978–83[1]
(In percent of GNP)

	78	79	80	81	82	83
Actual budget balance (a)	2.0	1.2	2.4	2.5	4.3	6.3
Cyclically neutral balance (b)	2.0	2.0	2.8	2.9	4.2	4.5
Cyclical effect of budget (CEB = (a) – (b))[2]	—	−0.8	−0.4	−0.4	0.1	1.8
Fiscal impulse (ΔCEB)	—	−0.8	0.4	—	0.5	1.7
Base year balance (1978) (c)	2.0	2.0	2.0	2.0	2.0	2.0
Structural budget balance (CEB + (c))	2.0	1.2	1.6	1.6	2.1	3.8

Source: IMF data.
—Denotes negligible amount.
[1]All budget balance data represent deficits. The data have been adjusted to a cash, calendar year basis and include social security transactions in accordance with standard IMF usage.
[2] −represents a contractionary effect.

ble not to make any exception for them in the assessment of fiscal policy per se, but to take account of their possible implications when analyzing private sector behavior. This is particularly appropriate if there is doubt as to how private spending behavior will respond to an inflation-related debt adjustment. Third, it could be argued that the budget's effects on interest rates (that bear on issues such as crowding-out) should not form part of the fiscal assessment, on the grounds that they are more appropriately treated in the monetary analysis. Nevertheless, the fact that such issues can be raised points to the need for caution in the use of the fiscal measures. It is important that some of the wider implications of the factors noted above are not lost sight of, even though they do not form part of the fiscal measure.

Another issue is how to draw inferences about unemployment, real output growth, or the rate of inflation from a given aggregate effect on demand of fiscal policy. Fortunately, it is possible to use the fact that inflation and real growth in a modern industrial economy normally respond to stimuli with different lags. Typically, in a context of moderate or low inflation, the initial impact of aggregate demand changes is on output or employment growth, as prices tend to react more slowly owing to the prevalence of wage and price contracts. It can be plausibly assumed that in a year-to-year analysis of the effects of fiscal policy, the impact is primarily on real output, while the inflationary consequences are manifested somewhat later. Notwithstanding some potentially important longer-term effects, fiscal policy can thus be employed in the short-run for the goal of smoothing output and, hence, employment fluctuations. In this approach, fiscal policy is used to offset shifts in the major private components of aggregate demand, especially private fixed investment, that generate short-run fluctuations in output.

Nevertheless, there is a question whether the longer-run effects of fiscal policy can reverse the shorter-run impact. As an empirical generalization it would seem that the demand effects of a budget deficit tend to be absorbed by the economy over the relatively short horizon of a year or so. Thus suppose there is a stimulative increase in the fiscal deficit for a given initial state of the economy. The increase in aggregate supply that is induced, partly through higher imports, will help restore equilibrium in a formal sense. In part there will be income-induced increases in private saving that offset greater government dissaving, with the remaining difference covered through a larger current account deficit. If the new budget deficit level is maintained, there will be no more (demand) stimulus, at least in a direct sense. Yet there will be effects that tend to influence the supply side of the economy and thus the trend rate of growth of the economy. This is because a higher fiscal deficit is associated both with financial effects, such as a higher rate of public debt issue that can cause interest rates to rise, and with possible direct real effects on the rate of capital accumulation and on the structure of incentives. Consequently, it is meaningful to undertake two analyses of fiscal policy effects, one on the shorter-run cyclical aspect and one on the longer-run trend.

For a longer-run analysis, it is especially important to decide on the appropriate level of a budget deficit that would be compatible with both internal and external balance over the medium term. Such a calculation requires an assessment of the sustainable current account deficit of the balance of payments, which, in turn, is based on notions of probable capital flows and also an estimate of the net private sector savings balance to be expected. On adding these two balances, an indication is obtained of the appropriate size of the "underlying" fiscal balance, which can then be used to assess whether or not the underlying balance associated with any particular year's budget is acceptable (see box for this calculation).

The U.S. business cycle

It is instructive to apply some of these ideas to assess the use and success of fiscal policy in stabilizing the real business cycle in the United States, which has exhibited substantial amplitude (Chart 1). What is intriguing, however, is the marked compression in the amplitude of the cycle in the postwar period as compared to the interwar years, and the reasons for this phenomenon.

In order to assess the possible role of fiscal policy, it is necessary first to identify its stance. Chart 2 uses the indicator of fiscal policy set out in the box (year-to-year change in CEB) to plot the initial aggregate demand effects of the budget. This series fluctuates considerably, especially in the postwar years, but this by itself does not convey much. The direction of policy is conveyed by the indicator plus a second series concerning fluctuations in employment growth. To stabilize employment growth, fiscal policy should obviously be more expansionary in periods of sluggish employment growth and conversely. However, Chart 2 shows that, with the exception of 1932, fiscal policy was generally procyclical in the interwar years—contractionary when employment growth declined and expansionary when it increased. This result is not surprising in view of the then pervasive belief that the budget be balanced at all times. In a sluggish economy the budget tends toward a deficit (as revenues decline), so that attempting to balance the budget involves a contractionary reduction in expenditures or an increase in taxes, which further aggravates the recession.

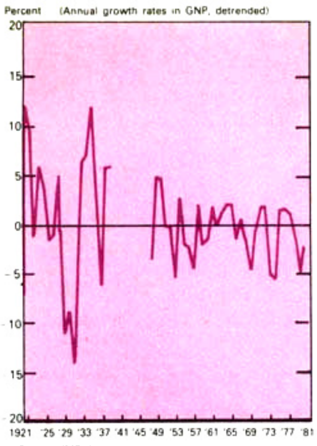
In the postwar period the fiscal impulses appear to be systematically countercyclical. In order to measure their contribution to stabilizing the real business cycle, it is necessary to examine major proximate determinants—principally private fixed investment and exports. The latter two so-called autonomous impulses, to which state and local government expenditures have been added, are plotted in Chart 3. As is evident for the postwar period, increases in the autonomous impulses have usually been accompanied by a contractionary fiscal policy, and conversely. The overall outcome for output and employment should now be more favorable and, indeed, is observed in the much more stable real business cycle of the postwar period that is shown in Chart 1. Although sophisticated econometric tests are needed to establish more precisely the contribution of fiscal policy, the association of a countercyclical fiscal policy and a smoother business cycle is highly suggestive.

According to the so-called macro rational expectations hypothesis, policy, when it can be anticipated, is ineffective. The results presented above demarcate two periods with distinctly different fiscal policy rules—a balanced budget rule in the interwar years and a countercyclical budget rule in the postwar years. Consequently, if the rational expectations hypothesis is valid, the switch in policy rules should not have mattered. But it appears to have done so, suggesting that policies can be effective provided there are some policy rules that will induce individuals to behave differently. A fiscal policy rule of balancing the budget, irrespective of the state of the economy, will make individuals excessively cautious in their spending behavior, whereas an assurance that the excesses of the business cycle will be contained could induce a steadier response.

Application to LDCs

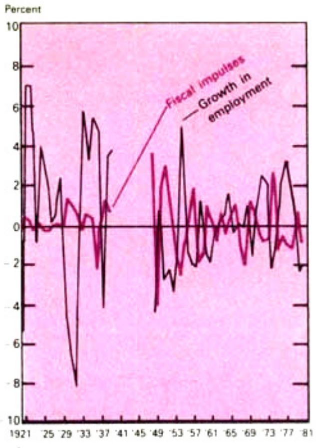
The criterion discussed for assessing fiscal policy is tailored to the circumstances of industrial countries. For applications to the developing world, account must be taken of their special structural characteristics affecting both the economy and the budget. For example, the problem of unemployment in many developing countries may not be the result of deficient aggregate de-

Chart 1
The U.S. business cycle, 1921–81



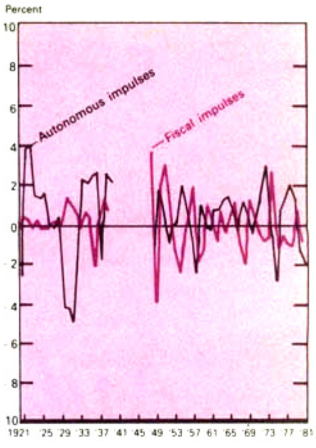
Source: IMF data.

Chart 2
Fiscal impulses and growth in employment *in the United States, 1921–81*[1]



Source: IMF data.
[1]Fiscal impulses in percent of previous year's GNP. Employment as detrended annual growth.

Chart 3
Fiscal impulses and autonomous impulses *in the United States, 1921–81*[1]



Source: IMF data.
[1]Fiscal and autonomous impulses in percent of previous year's GNP. Autonomous impulses are mainly private fixed investment and exports.

mand in the conventional Keynesian sense but of structural bottlenecks and impediments to the smooth functioning of markets. Hence, using a more expansionary fiscal policy to curb unemployment might simply worsen the balance of payments deficit or increase the rate of price inflation, with limited effects on employment. Nevertheless, even though structural unemployment tends to be higher in developing than in industrial economies, they, too, can be subject to cyclical influences, often related to an export cycle. A cautiously applied countercyclical fiscal policy may be appropriate—provided the country has adequate reserves, as the balance of payments deterioration will be more extreme when the budget stimulates demand and, hence, imports in a context of export shortfall. For many developing countries, the primary focus of a countercyclical fiscal policy is not on employment, but rather with smoothing the rate of absorption of domestic and foreign goods and services. The latter objective can be important in promoting growth and, certainly, the welfare of the economy.

Particular attention needs to be paid to the structure of the budget, including its financing. For many developing countries, the budget is highly sensitive to international factors. Export earnings from a few primary commodities may be a major source of budget revenue, while expenditures, particularly with regard to the development or capital budget, have a large import content. Even some current outlays may be powerfully affected by international developments, such as, for example, a deterioration in the terms of trade that raises the subsidy element borne by the government in the price of essential imports. Financing the budget deficit can also depend heavily on international sources, as the scope for domestic nonbank financing is limited, and a shortage of foreign exchange may constrain recourse to domestic credit creation.

If there is a heavy dependence on international factors, the assessment of fiscal policy undertaken at the level of the overall budget balance can be misleading. For example, a deterioration in the terms of trade or higher interest outlays on external debt can lead to a much bigger overall budget deficit, suggesting a more expansionary fiscal policy, although the domestic impact of the budget could actually be contractionary. The latter would be the case if domestic outlays are reduced or domestic activity is more intensively taxed in order to pay for the externally induced deterioration in the budget. A distinction should then be drawn between the domestic and foreign components of the budget, with items such as export duties assigned to the foreign component, for example, so as to identify their respective contributions to internal and external balance. Conceptually at any rate, this split of fiscal policy into separate instruments can be advantageous in promoting internal and external stability. Thus, in order to promote external balance, it may be preferable to aim at a surplus in the foreign budget balance, rather than in the domestic component, so as to avoid aggravating a local recession. The adjustments discussed above for identifying an expansionary fiscal policy need be applied to the domestic component only, as the foreign part is usually determined either at the discretion of the authorities or by external (exogenous) factors such as the terms of trade.

However, even with the domestic budget balance, more circumspection must be exercised in applications to the developing world for the purpose of assessing effects on the level of domestic activity. It is possible that the inflation lags are much shorter than in industrial countries, either because the underlying rate of inflation is much higher, or wages and prices are less sticky. Hence, an expansionary fiscal policy may have limited impact on the rate of growth of employment or output but more on the inflation rate and, via absorption, on the balance of payments. These structural differences must be taken into account in determining the appropriate goals of a short-run demand-oriented fiscal policy. Often among the developing countries, an expansionary domestic budget is the root cause of inflation and a deteriorating balance of payments, even though the overall budget balance may appear acceptable. This is attributable to the general dominance of the domestic budget in such economies, both as an initiator of activity and as a vehicle for increasing the money supply. A more satisfactory balance of payments will frequently require a less expansionary domestic budget impulse. For this purpose the summary indicator described earlier can assist in determining whether or not a budget is expansionary and the order of magnitude of the stimulative effect.

Robert Townsend for F&D

Sheetal K. Chand
holds a PhD in economics from the University of Western Ontario. He is a Senior Economist with the Research Department of the Fund and has published articles on macroeconomics.

Conclusion

Governments are typically concerned with many objectives and employ several alternative instruments to promote them. Fiscal policy is only one such instrument and the discussion above has focused on its use for the narrow purpose of stabilizing real output growth. Although important, this emphasis should not obscure the essentially short-run nature of the policy and the importance of maintaining a longer-term perspective on the appropriate budget profile. When focusing exclusively on the stabilization needs of the moment, it is quite easy for a budget to deviate further and further away from the norm compatible with medium-term growth and stability. A useful corrector is the attempt to ensure that the sum of each year's budget balance averages to that of the norm over a run of years for which the cyclical effects even out. F&D

Aid flows: the role of the DAC

Michael Blackwell
Economist, Fund Office in Europe

References to the DAC, the Development Assistance Committee of the Organization for Economic Cooperation and Development, are frequently made in discussions of development issues, but the exact nature and purposes of this Committee are often not well understood. The DAC is a forum in which representatives of the OECD's major aid donor members meet on a regular and frequent basis to discuss ways in which the quantity and quality of their aid can be improved. The DAC has no formal authority over its members, but it has succeeded in specifying certain minimum standards of aid quality—for example, relating to the financial terms and minimum "grant element" of official development assistance (ODA)—that its members have agreed to follow. Through its Secretariat, the DAC has played a major role in collecting and standardizing statistics on aid flows and has provided expert and high quality analysis on a wide variety of development issues.

Currently the urgent financial needs of the developing countries cannot be met fully by the International Monetary Fund, the World Bank, and other multilateral financial institutions. Access by these countries to the international capital markets has been drastically reduced and in the case of many of the poorest countries is nonexistent. Under such conditions, the need for the industrial and balance of payments surplus countries to increase the volume and quality of their aid flows is particularly evident. Unfortunately, the worldwide recession that was one of the factors leading to the acute difficulties of the developing countries has led also to pressures in the donor countries to slow the growth of—and in some cases cut back on—their aid budgets. The DAC is perhaps doing more than any other international body to address these critical problems and create a consensus for improving the quantity and quality of aid.

Origins and functions

In the late 1950s, as an ever-growing number of developing countries were becoming, or were due to become, independent, the leading industrial countries became conscious of the need for increased consultations on how to coordinate and increase the effectiveness of their national aid programs. In consequence, in 1960 the Development Assistance Group was formed with Belgium, Canada, France, the Federal Republic of Germany, Italy, Japan, the Netherlands, Portugal, the United Kingdom, the United States, and the Commission of the European Communities as members. In September of the following year, the Group was transformed into one of the major committees of the newly established OECD. Since that time, despite the later departure of Portugal, membership of the Committee has grown steadily with the addition of Australia, Austria, Denmark, Finland, New Zealand, Norway, Sweden, and Switzerland. Representatives of the International Monetary Fund and of the World Bank attend Committee meetings as regular observers.

The terms of reference and objectives of the DAC remain the same as those elaborated by its forerunner, the Development Assistance Group. In the "Resolution on the Common Aid Effort," adopted in March 1961, members stated that they were "convinced of the need to help the less developed countries to help themselves by increasing economic, financial, and technical assistance and by adapting this assistance to the requirements of the recipient countries." The Resolution then set out a number of objectives, of which the most important was: "to secure an expansion of the aggregate volume of resources made available to the less developed countries and to improve their effectiveness"—in other words, to improve both the quantity and quality of aid resources. Other objectives involved studies of aid needs, donors' aid performances, and burden sharing.

Participants in DAC meetings are usually members of permanent national delegations to the OECD, but they are often joined by officials from the ministries and operating agencies that deal with aid questions in the national capitals. Once each year a "high-level" meeting is held at which ministers, heads of governmental departments, or other senior officials discuss major policy questions. The Committee has a full-time chairman, usually chosen from senior academic or government circles; the present holder of this office is Rutherford M. Poats of the United States, a former Deputy Administrator of the U.S. Agency for International Development and Presidential Advisor. The Committee's secretariat is composed of staff members from the OECD's Development Cooperation Directorate, who, over the years, have undertaken a considerable amount of research on various development issues and who publish statistics that are a primary source of information on aid flows to developing countries.

Since 1967, the Secretariat has published comparative aid-giving performance tables, which indicate clearly which DAC members exceed and which fall short of the 0.7 percent ratio of ODA to GNP set as a target by the United Nations. The Secre-

tariat also estimates as accurately as possible the aid performance of the OPEC countries, the East European countries, and other non-DAC countries.

The International Monetary Fund and the World Bank benefit from their presence at DAC meetings by the access it gives them to information on trends in aid flows and on national development assistance policies. The flow of information, however, goes in both directions, and the DAC benefits from the unique expertise that the Bretton Woods institutions can provide; for example, the Fund is frequently asked to comment on the overall economic outlook for the aid recipient countries and the World Bank to explain developments in the multilateral aid field. The participation of representatives from the Fund and the Bank is particularly useful for the DAC in discussions of subjects, such as the "policy dialogue" or strategies for growth in low-income countries, that are of concern to all three institutions.

Among the most important of the DAC's regular meetings are the "Joint Aid Reviews." Each year the DAC Secretariat undertakes a thorough individual analysis of each member country's aid performance—covering such areas as policies, volume, terms and conditions, geographical and sectoral distribution, emergency programs, aid management and administration, technical cooperation, and environmental impact. In alternate years, each country can expect the report on its performance to be made the subject of a day-long discussion by other DAC members. At such discussions, a delegation from the country under review, often including the senior official of the national aid agency, comes to present the country's record and take note of the questions raised and the advice offered by other DAC members. It is through such meetings, in particular, that the DAC as an institution attempts to encourage each of its members to improve its aid performance.

Although undoubtedly the DAC has had some influence on its members' aid volume, it has had more influence on aid quality; for whereas the officials of national aid agencies present or represented at DAC Meetings have considerable responsibility for the way in which the aid cake can be cut, decisions on the size of the cake are generally taken at a governmental rather than at a ministerial level. In many DAC countries the Minister responsible for aid questions has often found it extremely difficult to convince government colleagues that increasing ODA should take precedence over other perhaps more politically popular claims on the country's limited resources.

It is probably for this reason that, as noted in a recent article in *Finance & Development* ("ODA from developed countries" by Ines Garcia-Thoumi, June 1983), although the aggregate volume of ODA has increased steadily in real terms over the years—by about 5 per cent per year since 1977—the DAC has found it extremely difficult to persuade its members to increase this assistance as a proportion of GNP. In fact, in the decade after the Committee's establishment the ODA/GNP ratio of disbursements from member countries fell from 0.53 percent in 1961 to 0.34 percent in 1970. ODA as a proportion of GNP remained close to that level throughout the 1970s, but has shown a slight upward trend over the past three years; indeed ODA disbursements in 1982 rose to 0.38 percent of GNP. Although this rise can be accounted for in part by a bunching of contributions to multilateral development agencies, it represents a significant achievement during a period of severe budgetary constraints in the donor countries. Some individual DAC members have been particularly successful in increasing their ODA/GNP ratios; indeed, ODA levels from Denmark, France, the Netherlands, Norway, and Sweden exceed the United Nations target of 0.7 percent of GNP.

Reaching a consensus to improve the quality of aid in different areas is often a lengthy process. Recently the difficulty of bringing so many disparate members together on issues that affect their budgets has been compounded by stringent economic conditions. This was evident in the recent discussions on "associated financing". The agreement that was finally reached on this subject provides a typical example of the way in which the DAC perceives a problem in the development assistance field, analyzes and discusses it, and then proceeds to adopt relevant standards or guidelines to which the members agree to adhere. At the beginning of this decade, some DAC members were becoming concerned at the increasing incidence of associated financing—the use of ODA in association with other resources as a means of subsidizing national exports to the developing countries. The problem was discussed at the "high-level" meeting in 1981, where it was agreed that members should seek to establish guidelines to limit such financing. In the many ensuing meetings, the difference of views among members on this subject was so great that agreement on what joint action could be taken seemed impossible. Finally, however, in June 1983, agreement was reached on a set of guidelines, which, among other things, specified that associated financing should be confined to priority projects and programs meeting developmental criteria for ODA financing and should be provided with a grant element of at least 20 percent. To the extent that these guidelines are followed, it will be harder for DAC members to use aid to boost their own exports rather than to assist development.

As the result of a similar process, DAC members reached agreement in December 1982 on guidelines on aid for maintenance of capital stock. In this case members had expressed concern that as a result of the scarcity of budgetary and foreign exchange resources, exacerbated by the world recession, governments in many aid-recipient countries could not afford to maintain existing installations and public services. The guidelines agreed on the need for more aid to be channeled into maintenance and rehabilitation, particularly in the least developed countries. The guidelines also called on DAC members to ensure that in the design of any new aid projects the planned level of ongoing maintenance would not be beyond the technical and financial capacity of the recipient country, and that, where relevant, the aid donor should commit itself to pay some of the maintenance and recurrent costs of the project over an appropriate period.

Apart from its goal-setting role, the DAC can also have a beneficial impact on the aid performance of its members by providing them with the opportunity to share their expertise and experiences. During 1983, for example, the DAC held lengthy discussions on the role of women in development, aid evaluation, how to strengthen the export capacity of low-income countries, aid to agriculture, and cooperation among aid donors—in each case, at the discussions around the table and in subsequent informal contacts, delegates were able to evaluate the experience of others and reflect on the implications for their own aid programs.

Overview

Although the DAC has not been as successful as its founders hoped in boosting the volume of official development assistance, it has served a useful and beneficial purpose. In many areas DAC statistics provide a unique source of reference on financial flows from the industrial to the developing countries. In addition, the DAC has done much to help coordinate the efforts made by the world's principal aid donors, and through effective moral suasion has spurred them on to improve the quality and, in many cases, the real value of their aid programs. While prospects for aid flows might not be as bright as many would wish, without the existence of the DAC they might well be dimmer.

The concessionality of foreign assistance

Toward a better understanding of this concept

Danny M. Leipziger

The basis for foreign assistance lending is that wealthier countries are willing to transfer resources to poorer nations at some cost to themselves. It is assumed that this cost—namely, the opportunity cost of capital—will be outweighed by the benefits the capital confers on the receiving country. Only if capital is transferred from a lower-return activity to a higher-return endeavor can global welfare be improved. This distinction between the rates of return on capital in the aid-giving country and the aid-receiving country is critical to a full understanding of concessionality in lending. In particular, it serves as the basis for ascertaining the circumstances under which a greater volume of concessional lending is preferable to a smaller amount of pure grant aid. It is also central to devising ways of extending the value of foreign aid.

To understand the definition of concessionality, consider that a $100 loan for ten years at 4 percent interest is "worth" almost $35 to a borrower who would otherwise pay 15 percent a year to borrow from the market. Since the net present value of repayments by the borrower totals $65, the grant element benefit is $35; to the borrower, the $100 loan is equivalent to a $35 grant and a $65 loan. But the lender faces a different opportunity cost of capital—say, 10 percent—and he receives repayments worth approximately $78 in light of his valuation of capital. Thus, the grant he is offering is $22, or 22 percent of the loan. In this case, therefore, the loan makes economic sense. It transfers resources to a more productive environment for capital, yielding a net benefit to society of $13. It should also be noted that the borrower is essentially indifferent between a grant of $35 and the aforementioned loan; however, the lender much prefers to offer the loan, since the effective cost to him of its $35 grant element is only $22.

Historically, this distinction between the benefit and cost of the grant element of a concessional loan has been blurred. Clarification could well lead to terms of assistance that are of greater value to recipients, while imposing no greater cost on benefactors.

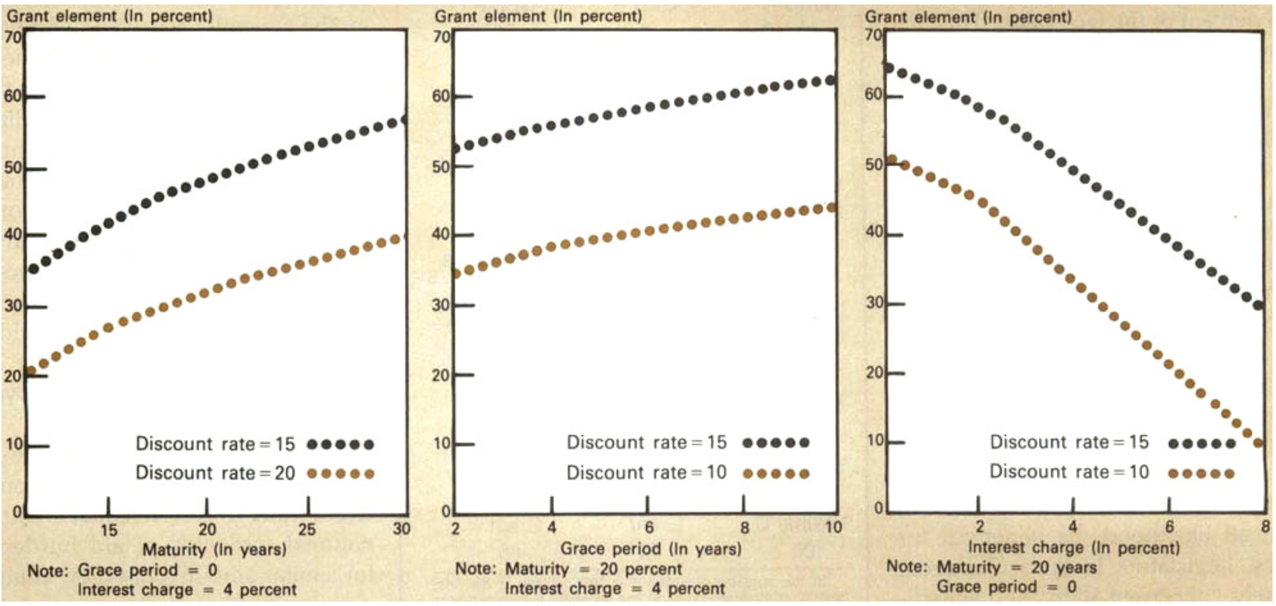
Calculating grant elements

The primary factors that determine the "grant element cost" to lenders and the "grant element benefit" to borrowers are the final maturity, the grace period, and the interest charges of the loan, as well as the discount rate (opportunity cost of capital) to either the lender or the borrower. For simplicity, consider a conventional loan—immediately disbursed and repaid in equal installments—although these assumptions can easily be relaxed. Chart 1 shows the effects on the grant element of changes in these three basic parameters—maturity, grace, and interest charge—for a donor whose opportunity cost is 10 percent and a borrower whose rate of return on capital is 15 percent.

A number of insights emerge. The first is that various combinations of terms can yield the same grant element level. This has important ramifications for foreign assistance policy. Second, it is clear that within a plausible range of variation, the interest charge affects the grant element calculation most significantly. Thus, for example, donors wishing to increase concessionality could do so most effectively by changing interest charges rather than maturities or grace periods. Third, it is clear that grant element calculations are extremely sensitive to the discount rate used. Conventionally, donors belonging to the OECD's Development Assistance Committee have used 10 percent as their opportunity cost of capital in gauging concessionality. But this discount rate far exceeded the average weighted cost of capital of major donors in the 1960s and, conversely, underestimated it in the 1980s.

Another complication in the calculation of grant elements emerges once the assumption of immediate disbursement is relaxed. In fact, loan disbursement profiles vary considerably. A structural adjustment loan by the World Bank, for instance, is disbursed very quickly and would yield a larger grant element benefit to a borrower than a project loan that disburses in accordance with the gestation period of the project. The difference can be quite substantial: a standard IDA credit for $100 made to a borrower whose return on capital is 15 percent would entail a grant benefit of $91 if immediately disbursed, but only $42

Chart 1
Grant element calculations

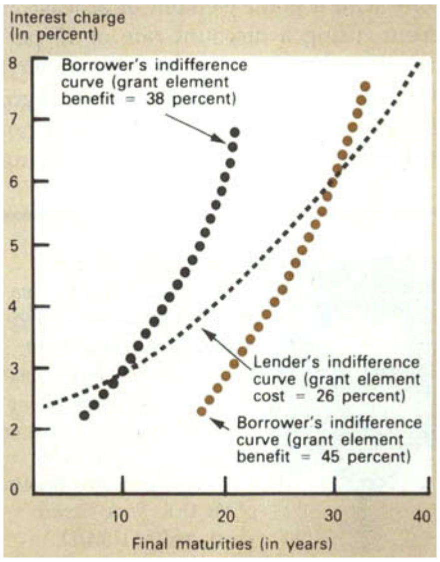


if disbursed according to the average IDA disbursement profile.

Disbursement patterns have a similar effect on the calculation of the grant element cost, depending on the use to which donors put the eventually disbursed funds. Therefore, the concessionality actually offered by donors for project financing may be up to half what it would be for nonproject loans that are immediately disbursed. In this sense, development institutions are in a peculiar situation because they often receive their funding from donors as it is needed for actual disbursements. Since the institution itself does not benefit from lagged disbursements, it would be inappropriate to recalculate the grant element on the part of the lender *qua* disbursing agent. Nevertheless, there is a clear overestimation in the conventional grant element calculations that assume immediate disbursement; these could be largely corrected if donors were required to deposit all contributions to international development institutions at the time of loan signing and if loan agreements were restructured to pass the funds on more rapidly.

Measuring the degree of concessionality of lending is therefore more complex than is generally acknowledged. In addition to distinguishing between the grant equivalent costs and benefits, more precision is required in the assumptions about disbursements, and, even more important, about the discount rate being used by both donors and recipients. As a practical matter, this will raise problems with respect to the appropriate value placed on capital by the borrower. Rates of return will usually not be reflected by the local cost of capital; capital markets in developing countries are rarely developed to the extent that capital costs reflect its scarcity value; moreover, interest rates are also frequently administered by the authorities. Still, the basic premises surrounding the supply and demand of concessional lending are well worth investigating.

Chart 2
Preferences of lenders and borrowers



Theory of grant elements

It is clear that there are potential advantages for both donors and recipients in exploring variations in terms, for any number of reasons. Consider, for example, the situation of developing countries facing liquidity problems. For cash-flow reasons, which in an ideal conceptual framework would affect the borrower's discount rate, a borrower may prefer a longer grace period on a new loan and would be willing to accept a shorter final maturity or a higher interest charge. Similarly, on the part of donors there may be binding constraints on the volume of assistance that can be offered, but greater flexibility on the terms.

Based on economic theory, borrowers generally wish to maximize the grant element benefit of concessional loans, while lenders attempt to limit their grant element cost. Each calculation of grant elements is based on the terms of the loan and the relevant discount rate. The simple illustration in Chart 2 shows which combinations of interest charges and final maturity will yield the same grant element cost when the grace period is ignored and the discount rate is assumed to be 10 percent. The lender's trade-off between higher charges and longer maturities is positive, as is the borrower's trade-off to achieve a predetermined grant element benefit, but the slope of the latter's indifference curve is steeper. This reflects the fact that a one-year increase in the final maturity of a loan will affect the grant element of the borrower relatively more than that of the lender be-

cause of the borrower's relatively higher value of capital.

The lender is essentially indifferent between terms A and B shown in Chart 2, since the grant element cost of either loan is about 26 percent of the face value. The borrower, by contrast, would much prefer loan terms B, however, in which his grant element benefit is 45 percent, than loan terms A, which yield him a grant benefit of 38 percent. Clearly, there exist optimal terms such that neither the lender's nor borrower's position can be improved without cost to the other participant in the transaction.

A conceptual discussion of terms assumes, of course, that both donors and recipients have well-defined preferences. In fact, most developing countries have been price-takers and volume-maximizers. Donors have, by and large, not shown any inclination to appropriate a larger volume of aid at harder terms, an outcome that could, in all likelihood, be beneficial for borrowers. Legislators in particular seem inordinately concerned with the expenditure side of the ledger and insufficiently sensitive to the revenue aspects of foreign assistance. This absence of a present value focus is especially acute vis-à-vis IDA appropriations, which are financed by donors over the project lives of credits that stretch out ten years or more.

The potential gains that could emerge from a clarification of the preferences of donors and borrowers are all the more significant given the current shortage of long-term, low-interest financing. A hypothetical borrower whose long-term return on capital is 15 percent would gain a grant element benefit of 75 percent from an immediately disbursed loan at a final maturity of 40 years, with a 10-year grace period, and 3 percent interest. The grant element cost to the lender, using a cost of capital of 10 percent, would be 60 percent. Under these circumstances, a hardening of terms to those noted in the table as Terms B (final maturity of 20 years, 10 years of grace, and 6 percent interest) would enable the borrower to receive a one-third increase in grant-equivalent funds at no additional cost to the lender.

The table shows another example in which both the donor and the recipient should be indifferent between Terms A and Terms C. The former provides a longer final maturity with a ten-year grace period, while the latter would involve a relatively shorter amortization period but a longer grace period. While at the conceptual level the borrower is indifferent, it is possible that short-term liquidity considerations, such as those currently prevalent among major debtor nations, would distort the long-term return on capital calculation. Indeed, the specter of default might make it considerably more useful for a borrower to delay repayments on new loans (through a longer grace period). Theoretically, this should show up in a significant increase in the borrower's discount rate, but his present-day preference may be almost infinite in extreme cases of illiquidity. Terms that are tailored to match these circumstances would be of significant assistance to debtors confronting a serious cash-flow problem.

Increasing the volume of assistance: an illustration

Discount rate[1]	Borrower[2] (15%)	Lender[3] (10%)
Terms A:	GEB =	GEC =
40–10–3	75%	60%
Volume A:	Grant =	Grant =
100	75	60
Terms B:	GEB =	GEC =
20–10–6	75%	30%
Volume B:	Grant =	Grant =
200	100	60

Improving the cash flow of assistance

Discount rate[1]	Borrower[2] (15%)	Lender[3] (10%)
Terms A:	GEB =	GEC =
40–10–3	75%	60%
Volume A:	Grant =	Grant =
100	75	60
Terms C:	GEB =	GEC =
30–15–3	75%	60%
Volume C:	Grant =	Grant =
100	75	60

[1]In the notation of terms, the first number is the final maturity of the loan (in years); the second is the grace period (in years); and the third is the interest rate (in percent).
[2]GEB = grant element benefit.
[3]GEC = grant element cost.

Policy issues

As already discussed, the discount rate is one of the major elements that determines the concessionality of assistance. Traditionally, a concessional loan has been defined as one with a grant element of at least 25 percent, using a discount rate of 10 percent. When such calculations were first made (by the OECD) some 16 years ago, the discount rate of 10 percent was a notional figure that was adopted as a working basis for calculation. Whereas in the earlier years it overstated economic rates of return in donor countries, in recent years it has understated considerably the opportunity cost of capital almost everywhere. But (given the generally accepted definition of official development assistance) if the discount rate had been adjusted to reflect prevailing interest rates, the concessionality of aid given as well as the total amount of assistance qualifying as ODA would have risen. This would have had an impact on perceptions of the donor countries' aid effort (a United Nations' sponsored aid-to-GNP ratio of 0.7 percent is the most generally used yardstick), but at the time it would call into doubt the practice of counting all loans with a concessional element above 25 percent as ODA.

Leaving aside the issue of the discount rate per se, current practice would allow two donors to receive equal credit in international measures of aid burden-sharing for similar amounts of ODA, although one donor might be offering terms that entail a grant cost of 26 percent and the other a grant cost of 99 percent. This bias could be eliminated by using a concept of "grant equivalent ODA," whereby a donor giving $100 in grant aid and $100 in concessional assistance with a grant element cost of 25 percent would be credited with $125 in grant-equivalent aid. While solving one problem, this concept would exacerbate another, however, insofar as it would make the selection of the discount rate more problematic, and more political. Any average selected would benefit those donors whose national rates of return on capital fell short of the average, and vice versa. The alternative of using individual national discount rates, as was suggested but rejected by the OECD in 1967, would add precision but would make intertemporal comparisons difficult, particularly in light of recently volatile interest rates.

While it may prove impractical to calculate the grant equivalent benefit with great precision, and it may likewise be difficult to use individual country discount rates to calculate the grant equivalent cost to donors, the international community can certainly improve upon its concessionality measures. A first step would be to accept the fact that there are two divergent discount rates involved in measuring the value of concessionality. The second step would be to improve upon the conventional 10 percent rule for donors. But the major innovation would be to illuminate the different benefits accruing to recipients from alternative sets of terms, with the hope of increasing the potential value of a form of assistance that is increasingly difficult to expand in volume terms.

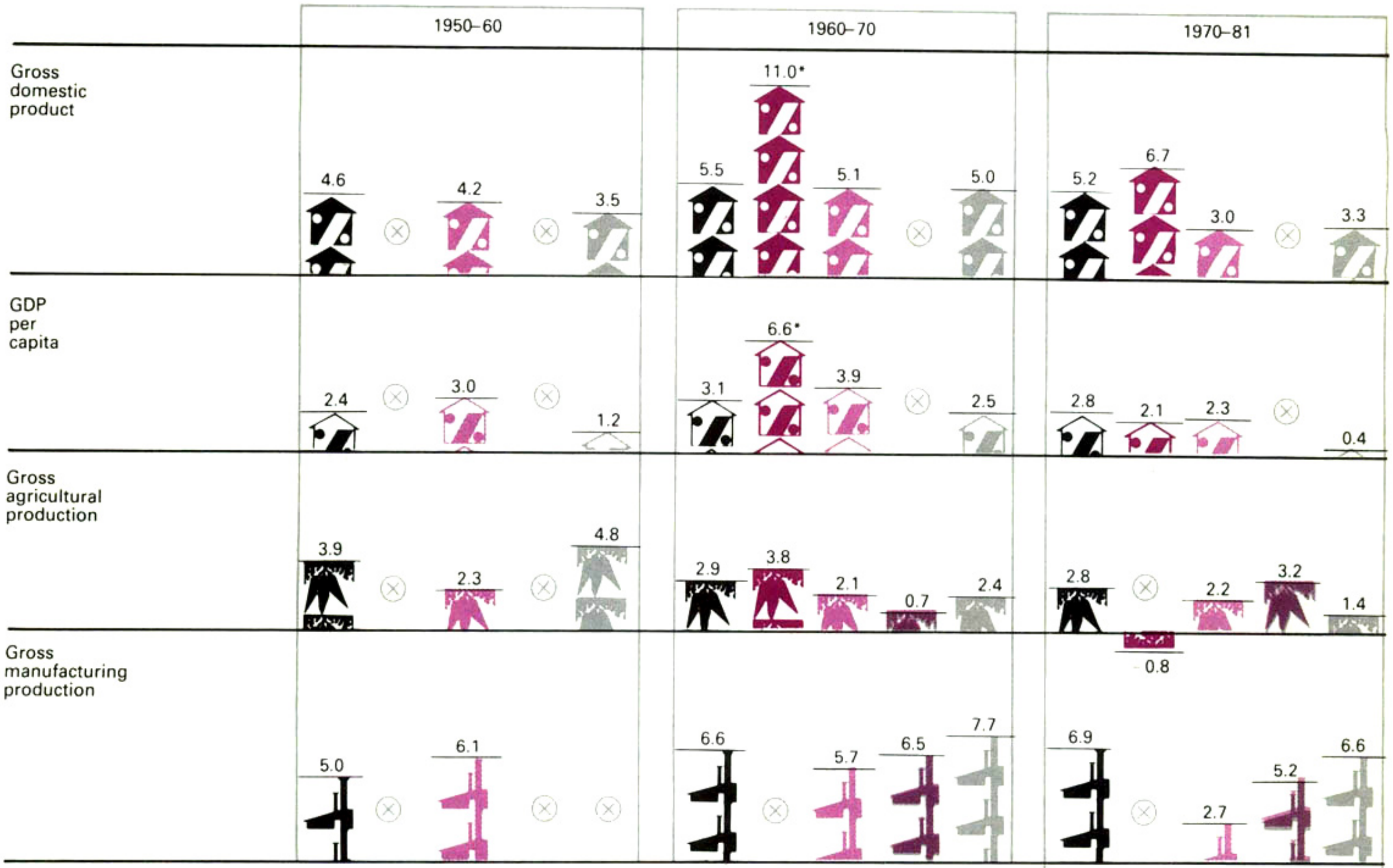
Giuseppe Franchini for F&D

Danny M. Leipziger
a U.S. citizen, is an Economist in the Financial Policy and Analysis Department. He holds a PhD from Brown University. Prior to joining the Bank in 1981, he was on the Policy Planning staff and in the Economic Bureau of the U.S. State Department, and at USAID.

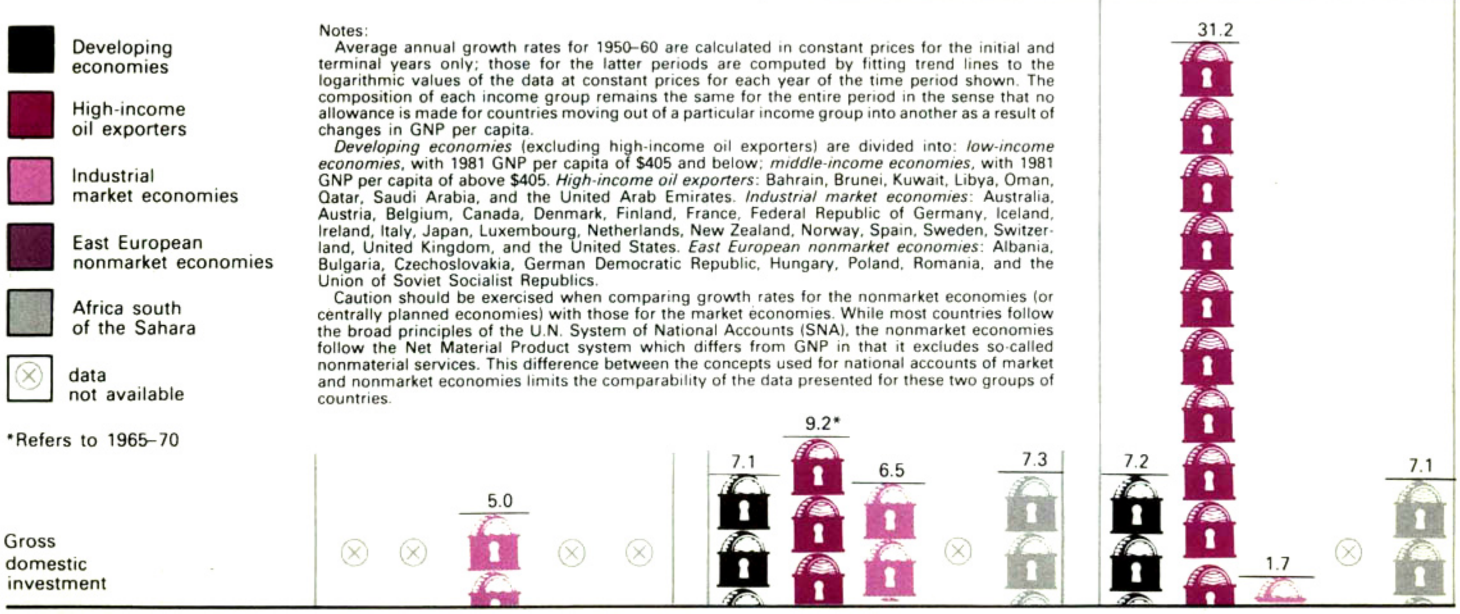
Indicators of growth

(Average real growth rates)

The accompanying charts represent a selection of a wide array of economic and social data assembled by the Bank's Economic Analysis and Projections Department and recently published in the two-volume *World Tables* (3rd Edition). The charts allow meaningful comparisons of the trends in selected indicators among developing countries belonging to different income groups for the past 2 or 3 decades. Indicators for one regional grouping—sub-Saharan Africa—are also included to provide background data to the articles on this area that appear on pp 5–17 of the journal.



Notes:
Average annual growth rates for 1950–60 are calculated in constant prices for the initial and terminal years only; those for the latter periods are computed by fitting trend lines to the logarithmic values of the data at constant prices for each year of the time period shown. The composition of each income group remains the same for the entire period in the sense that no allowance is made for countries moving out of a particular income group into another as a result of changes in GNP per capita.
Developing economies (excluding high-income oil exporters) are divided into: *low-income economies*, with 1981 GNP per capita of $405 and below; *middle-income economies*, with 1981 GNP per capita of above $405. *High-income oil exporters*: Bahrain, Brunei, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. *Industrial market economies*: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Federal Republic of Germany, Iceland, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Spain, Sweden, Switzerland, United Kingdom, and the United States. *East European nonmarket economies*: Albania, Bulgaria, Czechoslovakia, German Democratic Republic, Hungary, Poland, Romania, and the Union of Soviet Socialist Republics.
Caution should be exercised when comparing growth rates for the nonmarket economies (or centrally planned economies) with those for the market economies. While most countries follow the broad principles of the U.N. System of National Accounts (SNA), the nonmarket economies follow the Net Material Product system which differs from GNP in that it excludes so-called nonmaterial services. This difference between the concepts used for national accounts of market and nonmarket economies limits the comparability of the data presented for these two groups of countries.



Sharing knowledge

The dissemination of information by the Fund and the Bank

The principal objectives of the Fund and the Bank are to provide financial and technical assistance to their members, to give policy advice in their respective areas of responsibility, and to provide a forum for discussion and cooperation on international monetary and development issues. An additional—and important—function of the two institutions is to disseminate information that can promote a better assessment and understanding of economic and development issues and that can aid policy formulation in these areas. The information provided is of many types: statistical, technical, descriptive, and analytical. Much of it is unique, based on the broad international experience of the staff of the two institutions and the access they have to primary sources of information. *Finance & Development*, published jointly by the Fund and the Bank, is a prime example of this: it carries articles by the staff that discuss and elucidate the policies and activities of the two institutions but also cover topics of general interest in the fields of international economic relations and domestic economic policies. Readers, however, should be aware of the wealth of other information published and disseminated by the Fund and the Bank. Current information on this is available in the publication catalogues of both institutions, which are obtainable on request. We are happy to provide here a summary of the principal regular publications of the two institutions. (The Bank and the Fund also publish annual reports and books; this journal carries advertisements of selected titles.)

WORLD BANK

Technical Data Sheets*—*weekly $150 yearly*
up-to-date information on projects approved for Bank and IDA financing

Monthly Operational Summary*—*monthly $75 yearly*
earliest possible information on potential Bank loans and IDA credits

Research News—*3 times a year free*
description of current research

Commodity Trade and Price Trends—*annual $20*
a statistical handbook on the exports of developing countries

Abstracts of Current Studies 1983: The World Bank Research Program—*annual free*
abstracts of projects currently in the research program

World Bank Atlas—*annual $2.50*
data on GNP and population for all member countries

World Development Report—*annual $8 (paper), $20 (cloth)*
a research reference publication, comprising up-to-date statistics on major indicators and detailed analyses of aspects of development. (Also available in Arabic, Bahasa-Indonesia, Chinese, French, German, Japanese, and Spanish)

World Debt Tables, 1983–84 edition—*annual $75 (includes periodic supplements)*
statistics on the external publicly guaranteed debt of 103 developing countries

Urban Edge—*10 times a year free*
facts and ideas on practical approaches to urban problems in developing countries (also in French and Spanish)

Technical Papers—*intermittent individually priced*
informal working papers on technical issues

World Bank Country Studies—*intermittent individually priced*
a formal series of economic reports based on materials prepared in the World Bank

World Bank Staff Working Papers—*intermittent $180 (1 year subscription), also individually priced*
research and analysis on economic and social issues

World Tables: The Third Edition (1984)—*2 vol. set $65 (cloth), $32.50 (paper)*
economic and social time series for most countries

Bank publications are available from World Bank Publications, P.O. Box 37525, Washington, D. C. 20013 USA.
Those with asterisks are available from the Johns Hopkins University Press, Journals Division, Baltimore, MD 21218, USA.

FUND

IMF Survey—*every two weeks + supplements $25 yearly*[1]
a topical news survey on the Fund's work and matters of financial and economic interest (also in French and Spanish)

Balance of Payments Statistics—*monthly and yearbook $33 yearly*[2]
data covering 110 countries

Direction of Trade Statistics—*monthly and yearbook $30 yearly*[2]
7 years of annual data on geographic distribution of exports and imports

International Financial Statistics—*monthly and yearbook $75 yearly*[2]
standard source of statistics on all aspects of domestic and international finance (also in French and Spanish)

Staff Papers—*quarterly $12 yearly*[2]
work of staff members on monetary and financial problems

Annual Report on Exchange Arrangements and Exchange Restrictions—*annual. One copy free. Additional copies $12 each.*

Government Finance Statistics Yearbook—*annual $13*[2]
up to 10 years of data for 123 governments on detailed revenues and expenditures, plus summary data for state and local governments

International Capital Markets—*annual $5*[3]
a review of the magnitudes, terms, and prospects of current financial flows

World Economic Outlook—*annual $8*[4]
presents and analyzes short- and medium-term economic and financial scenarios, and discusses key policy issues for different country groups

IMF Pamphlets—*intermittent free*
covering various aspects of the Fund and its work (also in French and Spanish)

Occasional Papers—*intermittent $5*[3]
in-depth analyses of economic and financial subjects of importance to the work of the Fund

Fund publications are available from the Publications Unit, International Monetary Fund, Box A-841, Washington, D. C. 20431 USA.
All publications are in English; in some cases they are also available in other languages as indicated.
[1]Available upon request at no charge to university libraries and faculty members.
[2]Available to university libraries, faculty members, and students at one-half the listed rates.
[3]Available to university libraries, faculty members, and students at $3 per copy.
[4]Available to university libraries, faculty members, and students at $5 per copy.

Books

John Williamson

The Exchange Rate System

Policy Analyses in International Economics No. 5, Institute for International Economics, Washington, DC, 1983, 92 pp., $6.

This study attempts to provide a framework for a worldwide return to a structured exchange rate system. The great failing of floating exchange rates has been the large misalignments they have allowed to emerge. It would therefore be desirable, Williamson argues, for each individual country to identify the equilibrium exchange rate that would be appropriate from the standpoint of long-run competitive considerations. Ideally those exchange rates would then become the central rates in a set of mutually consistent and publicly declared target zones that countries would support by concerted intervention and, more important, by coordinated monetary policy.

Misalignments may emerge either from inefficiencies in the foreign exchange market ("market failure") or from policy mixes chosen with no concern for their exchange rate consequences ("policy failures"). Misalignments lead to a situation in which a country cannot expect to generate a current account balance to match its underlying capital flow over the cycle. The fundamental equilibrium exchange rate would, by contrast, produce a current account position consistent with the balance between saving and investment that exists in a cyclically neutral situation. That balance, and the underlying capital flow that it defines, depend, of course, on the macroeconomic policy regarded as appropriate over the medium term.

For this reason, finding a mutually consistent set of central rates for the world clearly depends on finding agreement on appropriate macroeconomic policies for all concerned. Shared objectives would help provide a basis for such agreement. Williamson sees no reason why interests should be competitive rather than cooperative in regard to levels of real resource transfer. Given a consensus on such transfers, he argues, negotiations on target zones for exchange rates that will realize them should not be particularly difficult. Agreement on target zones would then force the international coordination of macroeconomic policies that is needed for everyone's long-run good.

Apparently exchange rates are to be judged by the macroeconomic policies that generate them, and those macroeconomic policies, in turn, by the exchange rates to which they give rise. The apparent circularity is broken by linking both exchange rates and domestic policies to agreed levels of real resource transfer. To this critic, such agreement seems objectively hard to come by. Growth may be threatened by an exchange rate so soft as to create an external surplus that exports all investable savings abroad; growth may similarly be threatened by an exchange rate so hard as to render all domestic investment uncompetitive. Specifying the growth-maximizing exchange rate for each country does not obviously produce a consistent set of exchange rates for the world as a whole.

Hans Schmitt

Pedro Aspe Armella, Rudiger Dornbusch, and Maurice Obstfeld (editors)

Financial Policies and the World Capital Market:
The Problem of Latin American Countries

National Bureau of Economic Research and the University of Chicago Press, Chicago, 1983, ix + 293 pp., $36.

A common theme of this collection of papers presented to a National Bureau of Economic Research conference in 1981 is that progress toward financial integration among countries can give rise to new opportunities—and of course to new risks—for lenders and borrowers in the international sphere as well as impose tight constraints on domestic macroeconomic policies.

Though differing in subject and scope, the papers share a concern with the problems of economic management faced by open economies, particularly those in Latin America, and in this context they discuss issues of interest to policymakers. Some of the articles are theoretical and provide analyses of general applicability. Others are empirical and center either on the study of a particular country experience or on the investigation of a particular issue within a specific country.

An interesting setting for the volume is provided by Carlos Diaz Alejandro's paper, which surveys financial and exchange policy in Latin America in the 1930s as a basis for drawing parallels with the current decade. This historical survey is followed by several theoretical articles. Michael Mussa discusses economic integration and its advantages in the light of typical impediments to optimal integration strategy. Stanley Fischer uses optimal inflation tax analysis as a basis for arguing that seigniorage is relevant to the choice of an exchange rate regime. Nissan Liviatan discusses the effects of indexation on the functioning of an economy and argues that there is a market-determined equilibrium degree of wage indexation that is related to the nature of the shocks to which the economy is exposed. The last theoretical paper, by Michael Bruno, also deals with issues concerning an economy subject to real and monetary shocks and discusses the characteristics of a semi-industrialized country; this is relevant for international linkages as well as for macroeconomic management.

The empirical papers examine the experiences of three Latin American countries: Argentina, Brazil, and Mexico. Guillermo Calvo discusses the phenomenon of exchange rate overvaluation in Argentina from 1976 to 1980. Domingo Cavallo and Humberto Petrei, in turn, are concerned with the behavior of real interest rates in Argentina and how it has affected the financial position of private firms. Olivier Blanchard uses a formal growth model to address the subject of external debt and the current account deficit in Brazil. The paper's finding—that when current account adjustment is needed, it ought to come at the expense of consumption rather than investment—is not particularly controversial. In contrast, recent events have overtaken the paper's now more controversial assertion that, from the point of view of solvency, the Brazilian current account deficit, and presumably its foreign debt, were not matters of concern. Those events cannot but raise doubts about the appropriateness of the assumptions of the model.

Mexico is the subject of the three last articles: Guillermo Ortiz discusses the causes and implications of the growing importance of the dollar in the Mexican financial system, placing it in the context of a currency substitution model. In a related paper, Jose Lizondo explores the behavior of interest rate differentials between assets denominated in U.S. dollars and those denominated in Mexican pesos. Finally, Robert Cumby and

Maurice Obstfeld investigate the scope for sterilization by the Bank of Mexico in the presence of capital mobility.

In sum, this collection is a useful one. While no major new ground is broken, the papers do provide insights into the constraints and quandaries that policymakers face in a closely interdependent international economy, in general, and into the experiences of three major Lation American countries, in particular. As such, the book provides interesting reading for practitioners and scholars alike.

Manuel Guitián

Andrew M. Kamarck

Economics and the Real World

University of Pennsylvania Press, Philadelphia, 1983, x + 165 pp., $16.50.

Economic "laws" may not have changed but analytical techniques have, drastically—to an extent that most of the theoretical work being undertaken is all but incomprehensible to the majority of those interested in economic affairs, let alone to the ordinary reader. Economics has come a very long way from the "political economy" of the eighteenth and nineteenth centuries, but the relevance of the present-day "technology" of economics has been questioned by many.

This book gathers the various limitations that afflict the discipline of economics. Two chapters are devoted to the problems of measurement, and one discusses the conceptual difficulties of economics. These are followed by discussions of problems in specific areas of economics, including those in national accounting, the balance of payments, macroeconomic and microeconomic modeling, welfare economics and cost-benefit analysis, and the definitional problems of "capital" and "investment" in LDCs.

Most of Kamarck's points will be familiar to most responsible economists, and some are rather obvious (such as the statement on p. 60 that the national accounts are not a precise measure of the physical quality of life, welfare, or happiness). The chief beneficiaries of this book will be, to use a term coined by the author, the noneconomist "consumers of economic memoranda."

After a veritable litany of the shortcomings of economics as currently practiced, the reader will look forward to the author's conclusions and recommendations. Kamarck's "operational conclusions" are commonsensical rather than dramatic. In brief: economists (and those who listen to them) must be keenly aware of the limitations of the discipline; they must be more cautious; and they must make greater use of judgment. Specifically, there is need for a greater understanding of the data (their nature, accuracy, scope, and bias) as well as some experience in the actual gathering of data; the current emphasis on the technical sophistication of analytical techniques is to be decried; more work should be done on real-world problems and deductive reasoning should be supplemented by intuition, insight, and judgment; and in the field of policymaking the degree of ignorance about variables and parameters should be better recognized and greater reliance placed on the "Delphi" technique (tapping the experience and judgment of a wide circle of people).

Will Kamarck's strictures and advice be heeded? As far as the theoreticians and some model-builders are concerned, Kamarck's advice runs counter to the fashion of the times. He uses the term "science fiction" to characterize the activity of those model-builders more intrigued by technique than applicability. But this tendency is not limited to economics: other fields such as sociology, history, and even literature are proving vulnerable to our modern fascination with quantification, model-building, and technical virtuosity. For many economists, the intellectually stimulating is more gratifying than the "relevant," but their activities are, by and large, harmless and should be continued, though one may question the resources that are devoted to them. Of course all model-builders cannot be tarred with the same brush: forecasting models are designed with the specific purpose of being relevant and no one (including their creators) will take issue with the contention that they can be improved.

Of more immediate interest for the real world, which is Kamarck's main concern, is the usefulness of the book to policy-oriented economists and the "consumers of economic memoranda." How will they react? The niche that economists—in spite of all the deficiencies of their trade—have succeeded in securing for themselves and their consequent responsibility to provide sensible advice are the real problems here. In the real world, government ministers (and company presidents) want answers. They have to make fairly precise decisions on budgets, taxes, money expansion, prices, the level of the exchange rate, etc. Economists could behave in a more cautious, circumspect, intelligent, and wise manner, à la Kamarck. But frequently they are expected to provide precise, simple advice, whatever the shortcomings of the data and the analytical techniques. They, too, live in the real world.

This small, lucidly written book is a pertinent reminder of the pitfalls and shortcomings of our discipline and of the need to address them.

Bahram Nowzad

Michael Beenstock

The World Economy in Transition

Allen & Unwin, Winchester, MA, USA, 1983, xvii + 238 pp., $25 (cloth).

The Transition Theory, the centerpiece of Michael Beenstock's book, offers an intriguing explanation of the slowdown in growth of the industrial countries since the late 1960s and the accompanying shift in relative world economic power toward the developing countries. In the process, what seemed like purely exogenous events, such as the commodity boom of the early 1970s and the subsequent oil price shocks, become at best contributing phenomena and appear to some extent endogenous to other, more sweeping changes on the global economic scene.

Beenstock postulates that the initial, *autonomous* change came in the second half of the 1960s. During that period, the growth in manufacturing output of a dozen or so leading developing countries (today's newly

industrialized countries) accelerated from an already strong pace. The increased supplies of manufactured goods from the NICs began to compete successfully with a range of light and a few heavy manufactured goods from the industrial countries. This was possible due to lower wages in the developing countries, held from rising too rapidly by the influx of cheap labor from the countryside into the urban areas.

Sharply increased supplies of manufactured exports by the developing countries pulled up the prices of primary good inputs, thus making an important contribution to the relative rise of commodity prices, including oil. They also put competitive pressure on the manufacturing sectors of the industrial nations. Productivity of capital in the manufacturing sector of the industrial countries fell and resources began moving into the service sector. Industrial countries began to "de-industrialize" and, to the extent that labor could not shift rapidly enough away from manufacturing, unemployment rose.

This view contrasts with the more conventional analysis, which has developing countries linked to and dependent upon shifts in their industrial trading partners—their current account deficits thus driven by the policies of the North. Instead, the Transition Theory suggests that the predominant influence is the industrialization push in the South, which in the process of importing Northern capital for investment causes deficits in the current accounts of developing countries.

After three initial chapters that set out the Theory, the author launches into a set of direct and indirect empirical tests and corroborations of various aspects of his central proposition. The evidence is compelling at times, somewhat stretched at others. Along the way, the relative weaknesses of the empirical underpinnings of the competing Kondratieff cycle proposition and several other deterministic long-wave hypotheses are exposed. An imaginative historical section also examines a period (1860–1900) when Britain went through a transition analogous to that being experienced today by the industrial countries, as a result of the rise of the developing countries of that period—the United States, Germany, Russia, and France. The parallels to today's events are striking, although the length of something that is referred to as "transitory" is disturbing.

Chapters 7 and 8 are perhaps the book's weakest points. Chapter 7, while presenting an interesting little econometric global model, argues that "OPEC has been responsible to a large degree for the spiral of worldwide inflation and recession since 1973," which seems to contradict the author's own basic hypothesis that the recession in the North was largely due to the negative impact of industrial growth in the South. Chapter 8, on the other hand, opts to focus upon developments in the United Kingdom in 1950–80. This choice is puzzling, since the main premise and an attraction of the book is its promised emphasis on explaining the *common* causes of the slowdown in the North and hence its "global character" rather than the experience of any single economy. The book would have been more effective had these two chapters been omitted.

The concluding chapter covers some policy implications of the Theory. The message is optimistic, based on the author's assessment that the unemployment created by "de-industrialization" is transitional, a matter of a temporary mismatch of skills and opportunity. It follows that a solution is not to be sought through blocking or offsetting the disruption caused by the industrialization push from the South, for this would distort the efficiency of worldwide resource reallocation. Instead, the industrial countries should focus on their own factor markets, help reduce the rigidities in wages, and help design measures to encourage the unemployed to move to those areas where new jobs are being created. If these steps were implemented, the old rates of growth in output would return, making the relatively stagnant 1970s a period of once-and-for-all adjustment in the rate of growth of the industrial countries.

This would be all very well if the Theory were a one-time explanation of a soon-to-be-extinct phenomenon. But what happens if the industrial push of the first-tier NICs is followed by successive waves of industrialization shocks as new groups of developing countries get on the growth bandwagon? What happens if a string of transitions turns into permanent stagnation?

Peter Miović

Louis T. Wells, Jr.

Third World Multinationals:
The Rise of Foreign Investment from Developing Countries

The MIT Press, Cambridge, MA, USA, 1983, viii + 206 pp., $25.

Why do so many developing country firms produce abroad through some form of foreign investment rather than export goods or enter into licensing arrangements? The author attributes this new phenomenon primarily to protectionist threats to their export markets and to the contractual difficulties of selling their competitive advantages through licensing or other arrangements.

Employing data from overseas subsidiaries and branches established in 125 host developing countries by 963 parent firms from developing countries, Wells finds that the competitive advantages of Third World multinationals stem largely from the relevance of their experience in their own home markets—use of small-scale production technology, locally available inputs, and the manufacture of more appropriate products.

The advantages, however, are likely to be short lived; in most cases local firms in the host markets will be able to copy or develop similar skills. These advantages are also rarely protected by the mechanisms used by developed country multinationals. There is little investment in research and development; scant development of trade names to achieve market differentiation; and infrequent establishment of integrated manufacturing operations across countries to obtain economies of scale. Although the life cycles of many of these subsidiaries will probably be short, total investment flows will not fall off because firms with new competitive advantages will replace those whose advantages have eroded. Overall, Wells infers from these firms' operations a net benefit to the development process and to international relations—not so much due to economic gain as from an easing of political tensions over the issue of direct foreign investment.

Although some of the hypotheses are tested on limited data and the evidence for some of the conclusions is impressionistic, this is an impressive compilation of data in an area noted for scarce and unreliable figures and includes very instructive examples drawn from interviews in various countries.

Carl Dahlman

William R. Cline

International Debt and the Stability of the World Economy

MIT Press, Cambridge, MA, USA, 1983, 134 pp., $6 (paper).

A comprehensive analysis of the international debt situation and the main areas of public policy response, this book examines the origins of the current debt problem and the potential risk it poses for the stability of the international financial system, and assesses prospects over the next three years. Diagnosing debt problems to be mostly ones of temporary illiquidity rather than insolvency, Cline bases his forward-looking analysis on a simulation model for 19 major borrowers and concludes that debt problems are manageable provided that global recovery is satisfactory—citing the critical threshold OECD growth of 3 percent annually over 1984–86. The recommended policy strategy for industrial countries is to ensure a healthy global recovery and to approach the problem of debt on a case-by-case basis, mainly through country adjustment programs agreed with the Fund, other official financial support as needed, and a maintenance or increase in commercial bank net lending. Sweeping debt reform proposals and a severe tightening in bank regulations are, Cline argues, counterproductive, as these would choke off needed new bank lending. Contingency plans are preferred to deal with major disruptions. Aiming at a non-economist audience, the study covers all dimensions of the present policy debate and is far more balanced than most writings on the subject. Its one weakness might be that it does not deal more extensively with the consequences of failure to realize the major assumptions.

International Development Research Center

Aquaculture Economics Research in Asia

Report No. IDRC-193e, Ottawa, 1982, 128 pp.

The ten brief articles in this volume, the proceedings of a 1981 workshop, are a useful source of information on costs and production aspects of fish farming in South and East Asia where fish are becoming an increasingly important source of high quality protein.

Calvin Goldscheider (editor)

Urban Migrants in Developing Nations:
Patterns and Problems of Adjustment

Westview Press, Boulder, CO, 1983, xvii + 287 pp., $22.

This volume confirms current analysis of the economic and social prospects of rural-urban migrants in the developing world. Within a theoretical framework that seeks to explain the economic adjustment process, four case studies of rural-urban migration to Seoul, Surabaya, Bogota, and Teheran present data to illustrate the range of factors that determine the income levels and social mobility of migrants. This comparative review of the findings demonstrates that migrants frequently do better than urban-born residents; whether education is taken into account or not, the data suggest that the self-selection and motivation of migrants go far in integrating them into the labor market in developing country cities. The length of urban residence also explains income differentials within the migrant population, confirming the hypothesis that integration proceeds in phases as migrants take on increasingly remunerative and productive employment the longer they remain in town. The book, however, would have been more useful had it included more complete references to the large volume of country migration studies that already exist.

John Zysman and Laura Tyson (editors)

American Industry in International Competition

Cornell University Press, Ithaca, NY, USA, 1983, 436 pp., $34.95 (cloth).

A collection of essays on conditions in some of the major manufacturing subsectors in the United States that are under pressure from competing imports and the implications of the change in U.S. industrial circumstances for government and corporate policies.

George Macesich

Monetarism:
Theory and Policy

Praeger, New York, 1983, xi + 269 pp., $31.95 (cloth).

An extended and reasonably up-to-date review of the debate between monetarists, fence sitters, and Keynesians, on the suitability of monetary and fiscal instruments for the conduct of macroeconomic policy.

Daniel Yergin and Martin Hillenbrand (editors)

Global Insecurity

Penguin Books, New York, 1983, ix + 427 pp., $6.95.

This is a book with a purpose: to alert oil importing countries to the inevitability of recurrent oil scarcity and to the importance of formulating a coherent energy strategy. The opening chapter, by Daniel Yergin, gives a good analysis of the past oil shocks, the main elements of global adjustment, and the issues affecting the continuance of the adjustment process: the manner in which oil prices move, the rate of investment, and protectionism. The meat of the book presents two main oil scenarios—a moderately tight energy balance and a dangerously taut one, with periodic references to a third, more foreboding, possibility of a drastic curtailment of oil supply. The reasoning for these scenarios is well developed in a chapter by Robert Stobaugh. The remaining chapters on the United States, Japan, and Europe add the occasional insight and additional information but little by way of analysis. The chapter on developing countries is valuable but follows closely the World Bank's analysis that is available in other publications. Though a useful introduction to energy policy, the book fails to provide more penetrating analyses of key issues. There is only a cursory evaluation of the future role of coal and nuclear energy, and while several chapters stress the importance of moderating energy demand, there is little analysis of the effectiveness of policy in this area.

Primary Health Care:
The Chinese Experience

World Health Organization, Geneva, 1983, ix + 105 pp., SwF 14.

The success China has enjoyed in providing basic medical services has attracted much attention. While political commitment and social organization played a major role, the structure of the health care system and the mode of financing used were no less important and can conceivably be adapted by other countries. This slim volume, the outcome of a seminar conducted in China in June 1983, describes three aspects of the health care system in China: its structure, the organization of health manpower, and the financing of medical services. It should be a helpful introduction for health administrators in developing countries.

To our readers

Finance & Development is distributed without charge by the International Monetary Fund and the World Bank to **qualified** readers. Once your name is on our mailing list, you will continue receiving our publication **only if you return the poll card** that will be sent to you every three years. When you receive your poll card, you must return it promptly. Otherwise, your name will be dropped from our list.

The Editor

Letters

Recurrent costs

In researching the recurrent cost implications of the very rapid growth of the public sector capital stock in Saudi Arabia, I came across Peter Heller's article in the March 1979 issue of *Finance & Development* ("The underfinancing of recurrent development costs").

I found the article very informative, particularly as it appeared to point to an existing body of work that has been undertaken by the Fund and the World Bank. The article was, in fact, the most informative source turned up from a literature search that included a computerized key-word search. We were surprised how little of real value was revealed by this exercise, particularly in terms of "hard" information. The "myopia of planners" becomes easier to understand.

As there is much interest in this field, I wonder whether the author can suggest sources of hard information on the relationships between operation and maintenance costs and investment costs? In Saudi Arabia, where financial resources have not always been the limiting constraint, the structure of recurrent inputs for different types of projects is as important as their total value. As much of the recent development has been in facilities that are of a standard comparable with those of the developed world, sources of information on the recurrent-investment relationship in those nations would also be of interest. Information of this kind will be a useful complement to locally gathered data.

Conditions in the countries of the Sahel are radically different from those in the Arabian Peninsula. I would welcome readers' comments on an equivalent body of cross-sectoral work relating recurrent and investment costs for developing countries investing in advanced western-style infrastructure. (Send to P.O. Box 947)

Riyadh, Saudi Arabia — *Keith McDonald*

Peter Heller responds:

The literature on recurrent costs has indeed advanced since I wrote the article for Finance & Development. *A considerable amount of work has been done on the Sahel region of Africa, principally by the Club du Sahel of the OECD, which has sponsored many sectoral and country studies on the recurrent cost question, most of which are available from the Paris office of the Club. In addition, both Clive Gray of the Harvard Institute for International Development and André Martens of the University of Montreal are valuable sources of material.*

There is voluminous material on the specific recurrent cost requirements of projects and investments in different sectors of developed countries. However, this is not generally arranged under the heading of recurrent costs, but rather on a sector-specific basis or under the heading of deteriorating urban infrastructure. For example, George Peterson of the Urban Institute in Washington, DC has sponsored several studies of the latter kind, which are, I suspect, available.

EMS and the U.S. dollar

It is a pleasure to read the paper by Horst Ungerer; the paper gives an in-depth review of the European Monetary System (EMS) against the aims set out at its inception and includes well-presented and informative charts. Witness, for example, Chart 1 excluding the pound-sterling component in the ECU and rightly so, compared with the chart of *The Economist* (March 26, 1983, p. 47) that includes the sterling in ECU.

The purpose of this letter is to invite the author's views on an important factor influencing the performance of EMS that does not find explicit mention in the paper. It is true that the absence of clear signs of a convergence of economic policies has caused tensions within the EMS (the reflationary policies of President Mitterand forced a major realignment on October 5, 1981). However, another factor contributing to the tensions within the EMS is the volatility of the U.S. dollar. Just as the undue strength of the dollar is an important, albeit indirect, factor in the recent realignments of the EMS, its undue weakness had side effects on the first few realignments of the EMS. Because a weak dollar usually reflected a strong DM (though not fully the converse case), the dollar-DM axis seems to be an important and, at present, an uncontrolled outside factor in the EMS performance.

India — *Dr. R.K. Murti Poolla*

Horst Ungerer replies:

I agree fully that the volatility of the dollar, or more precisely the sharp fluctuations between the dollar and the EMS currencies because of the special role of the deutsche mark, may contribute to tensions within the EMS and exacerbate relative movements of EMS exchange rates. During the early years of the EMS, however, this factor played a much smaller role than could have been expected, since in 1979 the deutsche mark had been overvalued and the dollar undervalued. The subsequent steady strengthening of the dollar helped to conceal for some time divergencies in economic performance between EMS countries, thus actually lessening potential tensions within the EMS. While my article makes no explicit reference to this, the Fund's Occasional Paper No. 19, on which the article is based, discusses it at some length (p.5).

Government expenditure—and management

Pierre Landell-Mills' article, in the September 1983 issue, has prompted me to write. I have worked in various African countries since 1954 and I have witnessed a steady decline in standards of management—a decline that has largely been ignored in the media.

There are obviously many causes for the decline and some are more correctable than others. A major, and to some extent correctable, problem is the growing imbalance between government resources spent on salaries and those spent on travel and other items connected with government work. The trend in many countries is toward more and more government staff doing less and less work.

One wonders whether the World Bank could not assist more in helping Africans understand the decline that everyone knows exists. In particular, some analysis might show how governments have divided their finances and also how government structure has grown ahead of the economy that has to support it. Perhaps these things have been done already—but if so, they do not seem to have been widely publicized.

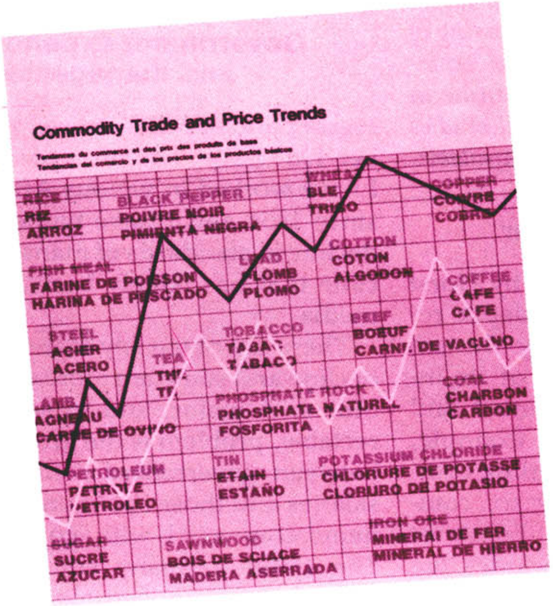
Chilanga, Zambia — *Ronald Watts*

Pierre Landell-Mills replies:

These issues were dealt with at greater length in the 1983 World Development Report, *which contains a bibliography that would be of interest. In particular, the Fund has recently published a study entitled* Government Employment and Pay: Some Comparisons, *by Peter Heller and Alan Tait (Occasional Paper No. 24).*

With regard to the query on whether the Bank might not "help Africans understand the decline that everyone knows exists," our efforts have gone in two directions: first, we issue general publications directed at an audience of senior African officials (for example, Accelerated Development in Sub-Saharan Africa *and the* World Development Report 1983*), containing policy advice that is also disseminated through a series of high-level seminars and workshops. Second, the Bank is in continuous dialogue with governments in an attempt to identify ways to strengthen institutions and to provide more effective technical assistance.*

Remarkable Statistics Tool Tracks Prices of Major Commodities of Developing Countries



"*Commodity Trade and Price Trends* has become a benchmark publication for people working in the commodities field. It's especially useful for those who need summary information about trade performance by individual developing countries."

Enzo Grilli, *Segretario Generale Per La Programmazione Economica Ministero del Bilancio e Della Programmazione Economica, Rome, Italy*

The 1983-84 edition, now available, provides long price series for major commodities, such as tin, rubber and aluminum. For the first time *Commodity Trade and Price Trends* also covers petroleum products.

The Bank draws on data going back to 1950 for the time series for 39 commodities, thereby enabling meaningful analysis by economists, market analysts and international investors. The time series for trends in export trade goes back to 1960.

✔ Clear tables and graphs show export trade data including:

- Values of primary commodities and manufactures as a percentage of total exports and imports
- Quantum and unit value indices of world exports, with terms of trade for major country groups
- Percentage of market shares of world trade for industrialized, developing and centrally planned countries
- Developing countries' exports and imports of major commodities (in dollars and metric tons)
- Commodity/country and country percentage shares of exports

✔ Statistics on the prices of the 55 commodities are also shown in tabular and graphic form for:

- Food items—sugar and selected beverages, cereals, meats, fruits and spices, oilseeds, oils, cakes and meals
- Nonfood items—fibers, rubber, timber and tobacco
- Fuels—coal and petroleum
- Nonferrous metals—aluminum, bauxite, copper, lead, tin and zinc
- Other metals and minerals—iron ore, manganese ore, nickel and steel
- Fertilizers—phosphate rock, diammonium phosphate, potassium chloride, triple superphosphate and urea

BANK BOOK ORDER CARD

Return to:
World Bank Publications
P.O. Box 37525
Washington, D.C. 20013 USA

Gentlemen: Send me ______ copies of *Commodity Trade and Price Trends*, 1983-84 edition $20.00 (add $2.00 per copy if air mail is desired).

☐ Enclosed is my check for $________________.
☐ Charge to my ☐ VISA ☐ Master Card ☐ American Express

Number ______________________________ Expiration Date____________
Signature ____
Name ____
Title ____
Address____
City, State, Postal Zone ______________________________
Country______________________ Telephone: (   ) ______________