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promoting private enterprise

better planning

China's economic reform

DEVELOPMENT STRATEGIES

Finance & Development

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Michele Iannacci for F&D

INTERNATIONAL FINANCE CORPORATION

IFC

Development through the private sector

A conversation with Sir William Ryrie, Executive Vice President of IFC

F&D ***What is the role of the International Finance Corporation, and how does it fulfill it?***
Ryrie The purpose of IFC is to promote economic development in the developing countries through the private sector, not by lending to governments but by investing in and lending to companies. We promote the growth of new companies, indigenous companies, and help to introduce more capital from private sources into developing countries. We do this because the private sector can provide a thrust for economic growth that comes from no other source. Unlike most other development institutions, IFC not only makes loans but takes equity, that is, it can own shares in the companies it supports. IFC is thus not merely a channel for funds, but it is also a participant in the development of the private sector in developing countries. The scale of IFC's own investments is not very large, but our task is to bring other investors along with us, in partnership, and so gear up much larger total investments. We like to have 10 percent or 15 percent in a project, the rest coming from local or foreign private investors or more usually a combination of both.

Over the 28 years of its life, IFC has expanded its activities gradually and increased the number of countries in which it has operated. It has been a participant in investments totaling about $27 billion, and, in this way, it has played an important part in the economic growth of some of those countries.

F&D ***How would you characterize government support for private sector activities in developing countries today?***
Ryrie There have been some very encouraging trends recently. There is now much more general recognition in developing countries, just as in developed countries, of the importance of the role of the private sector. We find many governments approaching us for assistance on matters such as legislation concerning foreign investment and the privatization of state enterprises. Generally, we are being welcomed by governments in many countries now, where 10 or 15 years ago there was much less enthusiasm for the private sector.

However, it is quite wrong to imagine, as I think some people do, that the strong support which IFC now has from its member countries is a reflection of the political color of some Western governments, or of their share in its ownership. The new recognition of the importance of the private sector in development is much more general, and we find it in many countries in Africa, Asia, and Latin America.

F&D ***Does IFC have much of a role to play in the poorer countries, especially those in sub-Saharan Africa, that do not have a well-developed private sector?***

Ryrie We have a role, we believe, in developing countries of all types. The nature of that role may vary: in some relatively more advanced countries there is already an established and growing private sector, and we can build on that and foster its further growth. In some of the very poor countries—the least developed countries in Africa and in other parts of the world—the task is more difficult. In many of those countries the company sector is only now beginning to emerge; and the need for IFC to be involved and to help to build it up is all the more important. Those countries, too, must benefit from the contribution that the private sector can make to development.

As an important part of our five-year program, upon which we have just embarked with the support of our member governments, we shall pay even more attention than in the past to fostering the development of the private sector in sub-Saharan Africa. I don't want to imply that Africa is the only part of the world that has low-income countries, but it does have many of the poorest countries of the world. That is why we are giving special emphasis to that continent.

F&D ***How does IFC resolve the dilemma of finding projects that are both financially viable and make sense economically?***

Ryrie I don't think that is fundamentally a dilemma. The IFC's task is to promote projects that the private sector is not likely to finance itself. It is written into our Articles that we are expected to do things that are not going to happen without our intervention. We don't compete with private investors: our mandate is to encourage and promote investment in situations that might be considered rather risky by the private sector. Sometimes our presence and the work we do on project design can reduce those risks. At the same time we have to make a profit. I don't think that is just a financial matter, because fundamentally, in economic terms, only profitable investment is good for development. If an investment is unprofitable, then resources are wasted. These are simple economic facts. Of course, there are some kinds of investments which, although profitable, are not the best way of promoting development. We have to make careful judgments here; but fundamentally I don't see a conflict between the pursuit of profit and the pursuit of development.

F&D ***Traditionally IFC has obtained its resources through the World Bank. In December 1984 it went to the market for $50 million. Why?***

Ryrie We have always had in our Articles the right to borrow from the market, but we have relied on the World Bank because the credit of the Bank is very strong and we could borrow from them on favorable terms. We will certainly continue to rely on the Bank for the greater part of our requirements. It seemed good to us, however, to undertake an experiment in raising our own finances.

We have not decided on any long-term policy of borrowing in the market. In the case of the December borrowing, we were presented with some rather favorable offers to borrow on good terms. Such borrowing helps to establish our name in the market and improve our relations with the financial community with whom we have to cooperate in a great deal of our business. With our relatively small requirements we have opportunities to borrow from sectors of the market which the Bank could not easily tap; so this borrowing seemed to make financial sense, both for us and for the Bank too.

F&D ***You said that you don't have any plans for major market borrowings. Could you expand on that?***

Ryrie We have made no long-term plans. We have authority from our Board of Directors to borrow up to $100 million, which in comparison with the Bank's borrowings is a small amount. We will do that, and then we will think again. As it happens we were able to borrow last December on very favorable terms and if similar opportunities present themselves, we may well borrow from the market again.

F&D ***Considering the fact that IFC has received approval for a doubling of its capital, and your plans for at least some borrowing from the market, will IFC be able to meet its lending targets?***

Ryrie I believe so. We need to identify enough good projects, projects that will be profitable and will be good for development. That will not happen by simply sitting in Washington and waiting for the business to fall into our laps. We have to go out and look for opportunities, look for the right business partners, put the right financial package together, find the right technologies, and do a bit of innovation. That is our task. The opportunities and the need are there: I am convinced of that.

Many developing countries have for some time relied rather too heavily on borrowing from commercial banks and now find that that source of capital has largely dried up. They need private investment and we are an agency that can help channel it to them. We can do this not so much through the money we invest ourselves, but through our role as a catalyst in attracting other investors. The contribution we make depends a good deal on other investors and technical partners we bring along with us.

F&D ***Are your lending rates competitive enough to attract borrowers?***

Ryrie Generally speaking, yes. There are a few countries where funds are available from other sources on favorable terms, where IFC money sometimes seems a little expensive. But on the whole our rates are such that people want us to invest. We borrow on commercial terms but at a favorable rate because our credit, through the World Bank, is very strong. Then we have to add something to cover our own costs which are not insignificant because we spend a lot of staff time on the appraisal and design of projects. We investigate them very carefully, even when they are small projects. That careful work is part of our role as a development institution, part of the special contribution we make to the projects in which we participate.

F&D ***What has been IFC's experience with syndication—where it makes a loan and then sells it off to a bank?***

Ryrie We have for a long time been fairly successful in selling some of our debt to commercial banks—so far we have sold over $2.5 billion in this way. I think that if we are more vigorous in that area there is scope for quite a lot more. Our plans, which I think are perfectly realistic, provide for about $3 billion of syndications over the next five years. This will free some of IFC's resources for other investments and involve commercial banks in more investments in the Third World.

F&D ***The promotion of capital markets in developing countries has been another aspect of IFC's work. Could you explain this?***

Ryrie This has been one of the most constructive and innovative aspects of IFC activity over the last 10 or 15 years. Many countries need to develop capital market institutions such as stock exchanges, securities companies, leasing companies, and financial intermediaries of one kind or another. IFC has a special department, partly financed by the World Bank, that has provided expertise in these areas to a number of countries. Korea is a special example where IFC has played a very important role. We are now extending this role to many countries which are financially less sophisticated than Korea but where we can do similar things. For example, we are establishing a leasing company in Bangladesh to help finance industrial investment. This is an area that has a good deal of potential for the future.

F&D ***How has the debt crisis affected IFC's investments?***

Ryrie The troubles that a number of countries—the heavily indebted—have had to face have led to measures of economic restraint that have often slowed up economic growth. That was inevitable. Take the example of Mexico where there has been a stabilization program that has slowed down the growth of the economy and constrained the expansion of business. Such conditions have made it more difficult for us to find new opportunities for investment. I think that is an inevitable but I hope temporary consequence of the problems that arose from the debt crisis. Once the stabilization program has succeeded, growth will resume.

But if you are asking whether we have had an increase in defaults or arrears in our investments recently, the answer is that we have. However, I don't link it so much with the debt problem as with the recession generally. It would be surprising, considering the deep recession that the Third World has been experiencing, if a number of the companies in which we have investments had not had problems over the last two years. The proportion of our investments that are in some kind of difficulty has risen a bit. I believe the situation will improve as economic circumstances improve. But we are now paying a little more attention to looking after our existing investments than we have done in the past.

F&D ***How does IFC deal with projects that are in arrears?***

Ryrie Of course we have arrangements for companies in which we invest to report on their progress; we do track their record and see how they are doing. If there are signs of difficulties, we send someone to have a look and to discuss the situation with the company. If the difficulties seem to be serious, we may have discussions with the other creditors—because we are never alone in these investments, we always have co-investors. In extreme cases, there may be a rescheduling of debt and sometimes quite substantial restructuring. We always do our best, not just to look after our own investment but also to try to make sure that the enterprise survives and continues, because our objective is that the company should make a contribution to economic growth.

F&D ***A larger role for IFC appears to be supported by its shareholders, especially the major ones. How do you see this emerging?***

Ryrie A part of that expansion will be achieved through the sort of things that IFC has always done. We will have to look for more business. To do this, we will have to expand our staff and be more vigorous in our search for investment opportunities. But we will also be developing some new methods.

I am planning to mount a substantial campaign to make the IFC better known in the developed world. We are not nearly well enough known in these areas. We want companies in Europe, the United States, and Japan that are interested in investing in the Third World, but are hesitating for one reason or another, to know about IFC and about the role we can play as co-investors and so be encouraged to proceed.

I think there is scope for us to do more by way of innovation: identifying technologies which can be a useful basis for investment in some countries and then going ourselves to find investors and suggest to them that they should join with us in such projects.

We may also expand our technical assistance activities, especially provision of advice to governments. A number of governments, I think, would like assistance on questions relating to private sector development; as I mentioned at the outset, these may include legislation covering foreign investment or the privatization of state-owned enterprises. These are areas in which IFC is well placed to provide useful advice. We may have to charge a fee because we are an organization that has to stand on its own feet financially. But I think there is a potentially quite important role for us to play in these areas.

F&D ***Coming to IFC, as you do, after a long career in the publi sector, are you having to make any philosophical adjustments i dealing with the private sector?***

Ryrie I suppose I am, but they are adjustments I make wit great readiness and willingness. I have long wanted to move tc the private sector or something much nearer the private sector. The IFC is really kind of a half-way house between the public sector and the private sector. I have been in the British Government as a civil servant for most of my working life, but on the financial side and in jobs that have been very much concerned with the Third World and with international banking.

The IFC, as I said, is a body that stands between governments and the private sector, so there are aspects of the job where some knowledge of the workings of government and of international financial affairs is not irrelevant. I have a great many colleagues here who have more commercial experience than I, and I hope that together we can do the job and provide the right balance of experience.

F&D ***As you begin your stewardship of IFC, what are your own hopes regarding the contribution it will make to economic development?***

Ryrie Let me answer that by saying that for many years I've been concerned in one way or another with the whole effort to help development in the Third World. It is very striking that the effort has been focused, for two or three decades, very much on governments and on the public sector: Aid has been considered a public-sector initiative and I think we're gradually beginning to realize that there is a neglected area of it.

We must not fall into the trap of thinking that because the private sector is important, you can handle it in the same way—the private sector can't be planned and organized in the same manner as public sector activity can. It's not a matter of managing growth from some central point. Its role is quite different. It is the catalytic role that I mentioned earlier. It's trying, in various ways, to make things happen that won't otherwise happen, to play a role in stimulating private sector flows. I find it very exciting to be involved in an organization where we shall be promoting this thrust, because a certain thrust and energy can come from the private sector which you will never find in the public sector. I think we now see the importance of that in the development process more clearly than we did in the past.

IFC's new approach to project promotion

Changes in project identification and development

Roger S. Leeds

Both the working environment and the operations of the International Finance Corporation (IFC) have changed significantly since April 1955, when the Executive Directors of the World Bank approved the proposed Articles of Agreement for the new affiliate. The mandate of the new institution was clear: to stimulate the growth of productive private enterprise in its member countries without competing directly with private sources of capital. The Corporation was expected to differentiate itself from private merchant and commercial banks by financing projects that would make a demonstrable contribution to economic development, as well as being profitable. At that time, no such institution existed to serve as a catalyst for the growth of private enterprise in developing countries. Although the fundamental objective has remained the same, a number of changes in IFC's operating environment have influenced how its staff go about the challenging process of promoting productive private investments in developing countries.

Some of the changes have been triggered by the growth and diversification of the Corporation's membership, which has quadrupled during nearly three decades of operations, from 31 countries to 126. With most of the newer members classified as low-income countries, the Corporation has moved to broaden its developmental role by investing in new sectors (e.g., energy and agribusiness) and new regions (e.g., Africa and the Caribbean). This growth and changing composition of the Corporation's program have required new approaches to identification and promotion of projects in the private sector.

Other adjustments have been precipitated by changes in the international investment climate, which today stands in stark contrast to the environment envisaged by the architects of the Corporation. During the Corporation's first decade of existence, private banks demonstrated only a passing interest in providing medium- and long-term credit to developing countries. But by the late 1960s a surge in private lending to these countries began, and the composition of foreign capital flows changed significantly as private banks became a primary source of funds for investment in many developing nations. Although this borrowing contributed to accelerated growth in a number of IFC's member countries, excessive indebtedness eventually led to severe economic problems in these countries. Recently many of these nations have also been suffering from painful recession and serious balance of payments problems. Weak demand, high interest rates, and shifts in relative prices have severely undermined the climate for private investment in IFC's member countries.

The rationale for stimulating private initiative has become particularly convincing recently. With public sector deficits burgeoning, it is incumbent on many developing countries to shift greater responsibility for production to the private sector, where the drain on public financial resources is less. Private enterprises and entrepreneurs, less dependent on the protection often associated with state-owned enterprises, are more compelled to operate efficiently in competitive markets. One of the key issues for IFC is to ensure that these private initiatives make economic, as well as financial, sense; there must be a net benefit to the country as well as to the enterprise's shareholders. When this occurs, the private sector is serving as an effective agent for economic development.

Even though it is a development institution, IFC faces many of the same challenges that most businesses face: markets are always changing; the investment climate is constantly in a state of flux; and competitive forces are rarely static. Part of the Corporation's responsibilities is to anticipate the key directions of change and to respond effectively.

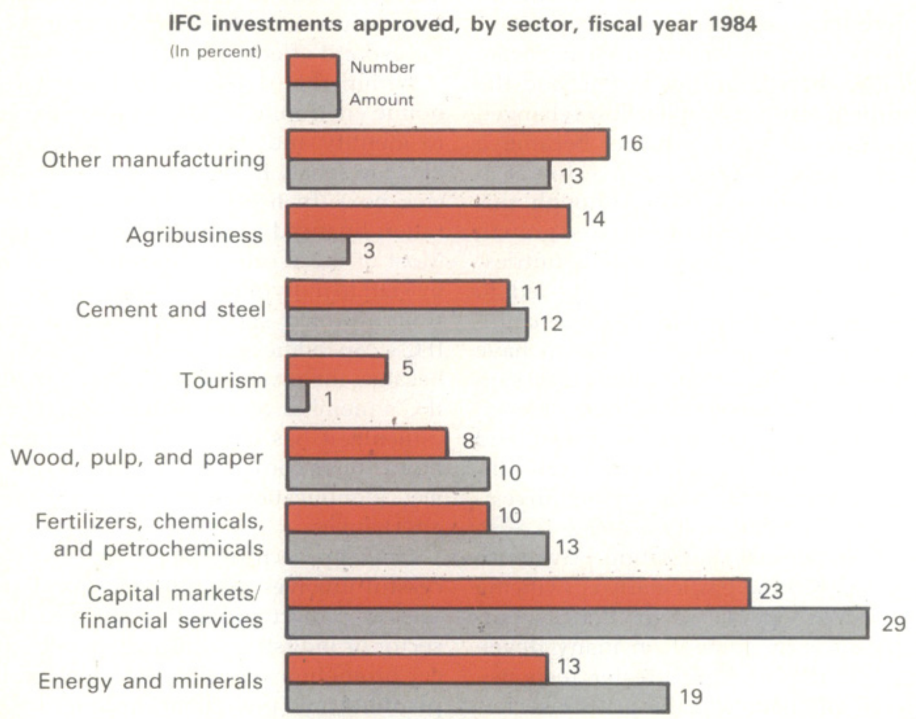
Within this dynamic international economic environment, IFC staff are expected to identify and develop projects that are likely to satisfy IFC's criteria for investment (see box). In fiscal year 1984, the Corporation financed 62 projects in 37 countries. Most of these projects resulted from visits by staff to individual countries, or enquiries from a project sponsor who was aware of IFC's capabilities and resources. However, because the investment climate in many of IFC's member countries has become more difficult, it has been necessary to supplement these conventional methods of project identification with more innovative alternatives.

One approach that is proving to be successful involves devoting increased attention to project promotion in a particular sector or industry. In IFC vernacular, project promotion refers to the identification, planning, and preliminary appraisal of new direct investment opportunities that would meet the Corporation's investment criteria. This definition suggests that project promotion is an exercise in discovery—seeking out new opportunities for private sector investment in Third World countries. The process, analogous in a private corporation to developing new business opportunities, places a premium on entrepreneurial creativity—a relatively free-thinking process of identifying and developing new types of projects for the Corporation. By definition, the process is not always neat; it is inherently risky; and inevitably it involves false starts and failures. But this creative process is essential in order to keep

The IFC at a glance

The IFC was set up in 1956 to supplement the activities of the World Bank by providing financing and investment expertise to the private sector in developing countries, without competing with private sector capital sources. It seeks to do this by bringing together entrepreneurs with both foreign and domestic investment capital in ventures that are not only productive but also support economic development in individual countries. The IFC operates with its own staff and capital. In 1984 the Board of Governors approved a capital increase that raised the IFC's current authorized capital from $650 million to $1,300 million. In addition to using its own capital, the IFC raises funds for its projects from international capital markets by syndicating loans and by underwritings and stand-by financing. Both its project and technical assistance work are instrumental in generating additional private capital flows to developing countries. Such flows have been estimated to be about five times IFC's investments. By the end of fiscal year 1984 the IFC had approved a total of 773 projects, with the Corporation's investments totaling about $6 billion. The total cost of those projects was almost $27 billion. About $2.5 billion worth of syndications accompanied these projects. During fiscal year 1984 IFC financed 62 projects in 37 countries. More than 80 technical assistance programs in over 30 member countries were also undertaken by the Corporation during this fiscal year.

In September 1984, Sir William Ryrie of the United Kingdom took over from Hans Wuttke of Germany, as the Executive Vice President of IFC.



Source: IFC, *Annual Report 1984*

abreast of changing conditions in the international marketplace.

Promotion is considerably more time-consuming and costly than IFC's mainstream activities, which are more transaction-oriented. In normal project appraisal work, the premium is placed on moving a prospective project expeditiously through the pipeline—individual projects are identified, appraised, prepared for Board approval, and then funds are disbursed. Normally, staff devote relatively small amounts of time developing a project for appraisal until there is a full feasibility study that can be reviewed in Washington. Project promotion, on the other hand, is a less systematic and a more deliberative process that can rarely be accomplished quickly. It deals with a particular sector or industry that offers new investment opportunities that could be replicated in more than one country. Considerably more time is devoted to developing the project even before the feasibility study is done. The end result of this relatively prolonged activity ultimately must justify the high cost to the Corporation in terms of time and manpower.

Project promotion of specific industries or sectors in IFC is designed to supplement the more traditional promotion work done in individual countries by the regional investment departments of the Corporation. There are a number of recent examples of this alternative approach to project promotion that demonstrate the potential benefits to IFC and its member countries. From relatively small commercial shrimp farming ventures to enormous oil and gas exploration programs, the similarities in the sector-specific approach to project promotion can be highlighted.

Shrimp farming: an illustration

It may be useful to examine a case of how IFC recently designed and implemented a promotion strategy in a specific industry in order to illustrate how the process contributes to IFC's dual objectives of profitability and development. Shrimp farming was singled out for a major IFC promotion initiative after a staff analysis determined that this particular industry appeared to satisfy many of the criteria that are important for success. The first level of inquiry, an economic and financial analysis of some existing commercial shrimp farming ventures, concluded that well-designed projects in this industry appear to aid general economic development and are also likely to have high financial returns.

The industry also proved to be attractive for promotion because it was relatively new. This provided an opportunity for the IFC to play a significant catalytic role in the early stages of the industry's growth and development by mobilizing financial and technical resources from other participants that otherwise would have been reluctant to participate. This role is particularly necessary in a relatively new industry, when the perceived risks are especially high.

Another important criterion for successful promotion is that the industry selected for a special promotion initiative should be well-suited to the economies of a number of developing countries, not just one or two. In the case of shrimp farming it was determined that numerous countries in different regions appeared to be endowed with the most important factors of production necessary to ensure economic efficiency in the industry (e.g., appropriate climate, coastal land availability, and water quality).

Analysis of the international market for the project output also is crucial. Sectors in which growth already is constrained by supply shortages are obvious candidates for project promotion. In the case of shrimp, the export market is well established and

growing. The market potential for shrimp farmers in particular is further enhanced because the total harvest of shrimp caught at sea, which represents more than 90 percent of total global consumption, peaked around 1977 and cannot be expected to expand significantly in the future. Thus, any major increases in global consumption must come from shrimp farms.

Finally, there is the important question of technology. Although relatively new, which suggests a high degree of risk by normal standards, the technology has reached a commercially viable stage. Visits to a number of operating shrimp farms by IFC staff provided convincing evidence that the technology was sufficiently well established and tested to be viable on a scale that would be attractive to IFC. Moreover, it was determined that this emerging technology was not particularly difficult to transfer and could be adapted in many developing countries. In conjunction with its promotion function, the IFC could play a significant role in facilitating the transfer of this new technology.

Implementation

Implementation of an industry-specific project promotion strategy depends on developing appropriate expertise within IFC (i.e., engineers and investment officers) for the efficient appraisal of projects in the new sector. Once IFC became committed to identifying a series of shrimp farming projects that could be financed, it was necessary for staff to develop a detailed understanding of the financing requirements, the technology costs and risks, and an acquaintance with individuals in the public and private sectors who have an interest or expertise in shrimp farming. This latter group would include prospective joint venture partners, technical consultants, shrimp traders, and market analysts.

The IFC promotion strategy in the shrimp farming industry concentrated on two interrelated sets of objectives. The first was to identify and develop new project opportunities that satisfy the Corporation's criteria for investment. For example, staff currently are appraising a number of shrimp farming projects that came to IFC's attention as a result of this special project promotion process. In one low-income Central American country, IFC has been instrumental in mobilizing financial resources for a $7.5 million shrimp farming joint venture with an experienced U.S.-based technical partner and a group of local investors. When completed in 1986, the project will produce about two million pounds of shrimp tails annually, with a projected f.o.b. value of $7.6 million. Not only are IFC's financial resources essential to ensure the project's viability but also it is highly unlikely that the local partners would risk their capital in the joint venture without the benefit of IFC's technical appraisal. It is hoped that the demonstration effect from the proposed project will stimulate other local investors to consider shrimp farming ventures, which could be earning large amounts of foreign exchange for the country by the end of the decade.

The second component of the promotion strategy is less traditional by IFC standards. In a limited number of countries, where there appears to be exceptional potential in the industry being promoted, the IFC may respond to government requests to conduct an assessment of the sector or industry, rather than a particular project. In the Philippines, for example, at the request of the government, IFC agreed to "(a) conduct an assessment of the current level of development of the shrimp farming industry and (b) make specific recommendations regarding how the industry should develop in the future, maximizing the participation of the private sector." The assignment entailed sending a staff mission to the Philippines, including the consulting services of a senior aquaculturist with a specialty in shrimp culture and a shrimp marketing expert. The team then prepared an extensive analysis of the shrimp farming sector and a strategic plan of action was presented to the Government for implementation. This analysis should contribute to accelerated investment in the Philippine shrimp farming industry. IFC has already received a number of project proposals from Philippine investors that are expected to meet its own criteria for investment.

Many of these same considerations—economic and financial returns, market prospects, project replicability, and technology transfer—also were addressed before proceeding with the largest IFC promotion initiative, in oil and gas exploration. In June 1984, the Board approved a $500 million program designed to combine IFC resources with those from private exploration companies to stimulate new oil and gas exploration initiatives in a number of member countries. Although this industry and shrimp farming are vastly different, the criteria applied by IFC to select these two industries for special promotion initiatives were similar.

This promotion process for specific sectors is a continual one; and the promotion staff is constantly assessing new industries that may satisfy the established criteria for promotion by IFC. The investment by IFC to develop these new project areas has been substantial. Whether it has been worth the investment of staff resources, depends on the Corporation's success in identifying, developing, and financing a number of projects in the same sector that are exceptionally attractive in terms of their potential profit and their impact on economic development. Ultimately, these experiments with project promotion must demonstrate that IFC can respond to an ever changing international market for its services and financial resources, and continue to make a significant contribution to "productive private enterprise," as mandated by the original Charter.

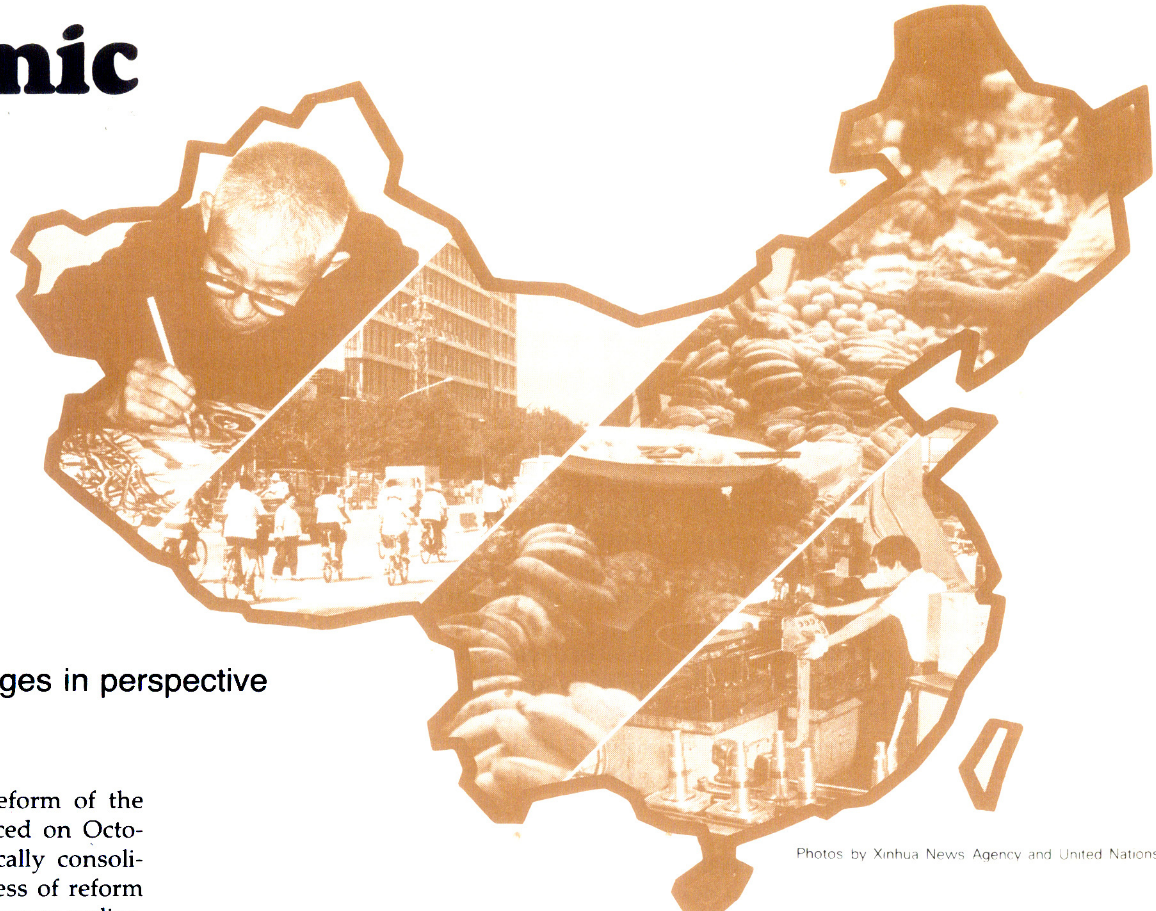
How IFC appraises projects

Project appraisals in IFC normally are carried out by a team comprised of an investment officer ("mission" leader); an engineer, who is a technical specialist in the industry being appraised; and an economist. After a prospective project has been identified and the sponsors have been evaluated, the first step in the appraisal process is a detailed desk analysis of the project feasibility study. If the results of this analysis are positive, the appraisal team undertakes a two- to three-week mission to the country, which includes in-depth discussions with the project sponsors and an extended visit to the project site. The objective is to evaluate all aspects of the project, including the capabilities of the sponsors and technical managers to implement the project, the technical viability of the project design, the extent of the market for the project's product, and the real financial and economic returns. Once the field mission is completed, a detailed appraisal report is prepared and presented to IFC's senior management for a discussion on whether to finance the project. Once it is approved, the final step in the process is to present the appraisal report along with the financing recommendation to the Board for final approval. The time required to complete the project appraisal cycle can vary considerably depending on the circumstances, but normally the time allotted from project identification to Board appraisal is about six months.

Giuseppe Franchini for F&D

Roger S. Leeds
a U.S. citizen, is a Senior Investment Officer with the IFC. Earlier, he was an investment banker with a New York firm. Mr. Leeds has published widely on international economics and finance.

Economic reform in China


Photos by Xinhua News Agency and United Nations

The recent policy changes in perspective

Luc De Wulf

With the Decision on the Reform of the Economic Structure, announced on October 20, 1984, China dramatically consolidated and accelerated a process of reform that had begun more than five years earlier.

In the late 1970s, in the years after the "Cultural Revolution" and in the midst of growing official concern with slow improvement in living standards, the Chinese leadership first expressed interest in new approaches to the country's economic development. While overall growth since the 1949 Revolution had been remarkable, it was achieved largely through the application of greater amounts of physical capital and manpower rather than through more efficient use of resources. There was concern that the sacrifices required were becoming disproportionate to the gains achieved. Past economic development, with its emphasis on large-scale investment, growth of heavy industry, mass participation, and egalitarianism, had left workers and peasants with only moderate increases in incomes and inadequate supplies of consumer goods. Citing excessive levels of investment, rigid administrative control over resource allocation, insufficient individual incentives, and undue emphasis on local, regional, and national self-sufficiency, the authorities laid the groundwork for economic reform.

The Four Modernizations Program, launched by the Central Committee of the Communist Party in December 1978, sought to put China on the path of sustained, balanced, and rapid development. It represented a break with past economic policies and announced the process of widespread economic reforms. Although it did not present a blueprint for the new economic system, it did indicate a commitment to trying different methods of resource allocation and distribution. Under this program, experiments were evaluated, modified, and implemented on a national scale when judged beneficial, and changed or eliminated when found inappropriate. From the very beginning, China's economic reforms have been part of a pragmatic and dynamic process, one that combined both bold steps forward and strategic retreats.

The 1984 Decision has distilled the essence of these various earlier reforms and has sketched the direction in which the authorities intend to steer the economy. As such, and for the first time, the reforms have been presented as a comprehensive, continuous undertaking, backed by the full authority of the Central Committee. This is expected to muster the support of those Party members who had been opposed to the reform movement on ideological grounds and of those who had been reluctant to implement what they viewed as a passing phenomenon. Although no precise timetable has been presented for the introduction of the reforms, most of them are to be in place within five years. Price, banking, and monetary reforms, however, are expected to require additional time.

This article surveys the nature and intent of these reforms; its coverage is selective and deals primarily with agricultural and industrial reforms. Reforms in the public finance and banking sectors are mentioned only briefly and, for lack of space, China's efforts to attract foreign direct investment and increase international trade are not examined. (A subsequent article will deal with these and other aspects of the reform—the Editor.)

Agriculture

China replaced its agricultural cooperatives with communes in 1958 but the reorganization, followed by two years of disastrous weather, so disrupted agricultural production that it took more than five years for it to regain the 1957–58 level of output. Commune production subsequently realized moderate growth, but often at high costs. More rapid increases in production were hampered by an incentive structure that did not link remuneration to effort, by detailed high-level planning that often neglected to take local circumstances into account, and by political interference in production decisions.

To remedy this, a production responsibility system was introduced on an experimental basis in two provinces as early as 1978. Success there in increasing productivity gradually led to the introduction of the system in most rural areas, including some state farms. Production responsibility systems differ slightly from one another,

but all are based on a contractual relationship between the commune and a group of farmers, a household, or an individual. These contracts specify the amount of land to be cultivated, the amount and type of produce the contractor is to deliver to the state, and the required tax payments and contributions to the welfare and investment funds. The contracts, as they refer to access to land, were originally valid for 5 years, and have, since January 1983, been extended to 15 years (50 years for orchards); amounts of produce, and other aspects of the contract, are adjusted more frequently. Contracts can be passed on to children or other beneficiaries, and can be sold with the permission of the commune; compensation for improvements, such as irrigation or application of fertilizer, may be negotiated. The contractor is free to dispose of excess produce in free markets. These free markets, which had all but disappeared during the "Cultural Revolution," have been revived, and their operation has been facilitated by state authorization permitting long distance transportation and marketing for all agricultural produce—even grain, a commodity whose trade had been a state monopoly since 1949. Simultaneously, the commune's production and economic responsibilities have been divorced from its administrative functions, which now reside with the newly revived townships.

The response to these changes has been impressive and is credited with a large share of the 9 percent average annual growth in agricultural production realized in 1981–83. Admittedly, increased procurement prices, which rose 20 to 25 percent in 1979, favorable weather conditions, and the shift back toward greater regional specialization contributed to this performance. Yet both personal observation and reports from experts indicate that the system has infused the rural areas with a new enthusiasm and has been much better able to draw on the resourcefulness of the peasants.

The rural reform, however, has not come without problems. The more efficient utilization of the rural work force has made about one third of the agricultural workers redundant and created the need for alternative forms of employment. In order to avoid the social and economic problems of large-scale rural-urban migration, the authorities continue to control such migration strictly. Therefore, new employment possibilities have had to be created in the rural areas themselves. To meet this need, industrial production in the rural areas and nonagricultural activities, such as livestock breeding, water resource management, commerce, handicrafts, catering, construction, and transportation, have been stimulated and are currently, in fact, the fastest growing sectors in the economy. About 10 percent of the rural work force is now employed in the industrial sector, while between 10 and 15 percent is engaged in various specialized nonagricultural occupations. In more advanced regions, such as Jiangsu, the share of industrial employment is much higher, but further progress will be needed to meet this challenge.

Another problem that followed the success of the production responsibility system has been the emergence of acute shortages of consumer goods, agricultural inputs, and construction materials. The rural population now possesses greater purchasing power, but the supply of goods has not kept pace with demand. Authorities have been making more industrial production available to the countryside, and moderate progress has been made.

Industry

The Four Modernizations Program, which initiated the reforms, gave equal emphasis to urban and rural areas. Yet reforms in the rural areas have proceeded more speedily and are now virtually completed. In the urban areas, where economic relations are much more complex, reforms have been implemented more slowly, with more time devoted to experimenting. On the basis of this experimentation and heartened by the success of the production responsibility system in the rural areas, authorities have indicated in the 1984 Decision a willingness to accelerate urban reforms.

These reforms principally seek to redress inefficiency in the state-owned industrial sector, which the authorities have laid to several interrelated factors. First, mandatory central planning, which was inspired by the Soviet model in the 1950s and may have been proper for the simple economy of that period and in the context of forced growth based on the development of heavy industry, is now seen as insufficiently flexible to deal with the greater complexity of an expanding industrial base. Second, enterprises were constrained in their pursuit of efficiency. Treated as departments of government agencies and managed as such, they were, until recently, required to hand over all their profits to the budget, which in turn covered their losses and provided their investment funds in the form of a grant from the budget. Supply and distribution channels were rigid and unresponsive to shifts in demand; wages were set to give more weight to seniority than job performance or enterprise profitability; bonuses were prohibited; and recruitment and dismissal of workers were outside the purview of the manager. Third, the price structure was greatly distorted. This complicated the assessment of enterprise performance, hampered the introduction of technological innovation and the rationalization of the production mix, distorted consumption patterns, and caused both shortages of goods with low profit margins and excess production of goods with artificially high margins. Because consumer prices for many goods were less than procurement prices, the budget incurred large subsidy expenditures. Fourth, the preeminent role of state-owned and collective enterprises, combined with a disregard for the contributions that could be made by the private sector, deprived the economy of a source of creativity and left whole areas of consumer demand unsatisfied. (The private sector refers to small enterprises run by individuals or groups of individuals.)

The purpose of the industrial reforms, therefore, was to modify the economic environment within which enterprises operated so that they would become independent economic entities, responsible for their own profits and losses, and endowed with both the incentives and the authority to improve their efficiency and profitability. The essence of these reforms can best be captured by looking at their impact on planning, enterprise management, prices, and the role of the private sector.

Planning. In the course of the next few years, the scope of mandatory planning in China will be narrowed, while that of guidance planning expanded. Planning will concentrate on outlining the direction the economy should take, while increasing use will be made of macroeconomic policy instruments, such as correct price signals, taxation, credit and interest rates, profits, and wage differentials. The 1984 Directive indicated that in the future mandatory planning will be restricted to major products that have a direct bearing on the national economy and on the standard of living. The central plan will include output targets for energy, rolled steel, cement, basic raw materials for the chemical industry, and synthetic fiber. In agriculture, targets will be used for cereals, cotton, edible oil, tobacco, jute, pigs, and fish products. All in all, mandatory planning will eventually pertain to only 60 industrial and 10 agricultural commodities, down from 120 and 29 at present. Other products will be more broadly regulated through a guidance plan, with state and collective enterprises and the private sector allowed to compete among themselves. Although no statistics are yet available to gauge the importance of the commodities under the mandatory plan, it appears, for the near future at least, that they will continue to constitute the bulk of total production but they will comprise a much smaller share of the number of commodities.

The reform effort has squarely faced the possibility that some enterprises outside the sphere of mandatory planning may not be able to withstand competition. Already a number of enterprises that were unable to meet the required quality or cost standards have been merged with other enterprises, forced to change their line of business, or simply closed down. These consolidations differ, however, from bankruptcy in market economies, since the state attempts to minimize both the loss of productive capacity and the transitional problems for the workers affected.

Enterprise management. The new reforms recognize that in order for enterprises to be run as independent economic entities and assume responsibility for their own results, they must be given greater authority and greater incentives to work efficiently. This has led to the introduction of a whole series of interconnected reforms.

Enterprise management is to be gradually separated from the government agencies that, until now, have taken most managerial decisions. These agencies will now set broad policies, coordinate production, and assist enterprises in the achievement of their own objectives. With this newly acquired independence, enterprises are being made increasingly responsible for their own profits and losses, and a system to determine which share of the profits will be retained by the enterprises is being put into place.

After experimenting with several profit-sharing and income tax schemes, an income tax for state-owned enterprises was introduced in mid-1983 and was fully implemented by the end of 1984. The rate of this income tax has been set at 55 percent. But as price distortions affect enterprise profitability often more than does managerial efficiency, an adjustment tax has been applied to the after-tax profits, to bring profits more or less in line with those retained before the introduction of the income tax. The new system also has allowed enterprises that improve their profitability to retain the larger part of increased profits. Although the new tax system is intended to provide a legal basis for the disposal of profits, and therefore streamline the relations between the supervisory agencies and the enterprises, it will not yield its full potential until the price structure has been rationalized.

Directors of enterprises are now to be appointed by supervisory departments, and their authority has been broadened under the new reforms. Workers' Congresses continue to exist, but their role in managerial decision making has been circumscribed. The managers have now been allowed greater discretion in the recruitment and dismissal of workers and do not have to absorb workers assigned by the employment department, as was the practice in the past. They now have the authority to organize job-specific examinations and recruit accordingly. As a corollary, workers have been granted somewhat greater mobility, and school graduates have been encouraged to submit job applications to various employers. Managers have also been given greater discretion to promote better and more qualified workers and to dismiss those that do not perform well.

The wage policy has also undergone rapid change. In 1979 enterprises began to give bonuses to more efficient workers. These bonuses initially could not exceed 2.5 months of basic salary, a restriction abolished in 1984. Now enterprises can grant the bonuses they choose, but a progressive tax has been levied on enterprises that grant bonuses in excess of 2.5 months of basic wages. The regulations specifying that only enterprises that achieve profits and improve their performance can grant bonuses have also been strengthened. A common problem, however, with the bonus system has been that managers often distribute them in a egalitarian fashion, thus undermining their very purpose.

The October 1984 Decision endorsed the policy of bonuses but went one step further and recommended that the wage system itself be reformed, widening the wage differentials between various trades and jobs, and increasing the remuneration for mental work. These deviations from the strict egalitarianism that long had been the hallmark of much of China's development model are deemed necessary as the previous system was felt to have undermined workers' commitment to tasks and bred mediocrity. The authorities, however, do not feel that gearing remuneration of workers to their contribution absolves society from its responsibility of taking care of the less fortunate.

Prices. The present distortions in China's price structure are largely the result of adherence to a system of fixed prices that gradually became divorced from productivity developments and unrelated to international prices. This allowed wages to remain stable for very long periods, but the budget eventually had to absorb the increases in procurement costs for basic necessities. As a result, in 1983, subsidies for basic necessities constituted nearly one fourth of budgetary expenditures.

These shortcomings in the price system were first recognized in 1979 but adjustment was not believed possible within the context of the Sixth Five-Year Plan (1981–85). A consensus, however, appeared to develop that price reform would be undertaken in earnest in the Seventh Five-Year Plan (1986–90). Partial measures were taken in the meantime, and some prices were changed. Foremost among these was an increase in agricultural procurement prices in 1979. Since consumer prices were only partially increased, however, budgetary subsidies rose sharply. Selective price increases have also been granted for commodities that were in short supply or whose production costs had increased substantially, while prices for certain other goods were reduced, often to help producers unload overstocks or to keep down increases in the cost of living. In addition to these changes, some producers were authorized to let prices for some of their output fluctuate within a fixed margin around the state-fixed prices or to negotiate the price of a share of their production. These more flexible price practices were largely restricted to overstocked commodities and to production in excess of the state-fixed production quota. But prices of commodities of lesser importance were increasingly freed from state control and were allowed to be determined by market forces. Similarly, the prices agreed upon between buyers and sellers on free markets were totally freed, although in principle the state retained the authority to intervene whenever prices would otherwise increase too fast.

The 1984 Decision has given greater urgency to the implementation of price reform. Although no definite timetable has been announced, it was made clear that prices will change, and change soon, albeit gradually. In essence the Decision announced that the scope of state-controlled prices will be reduced, while that of prices agreed between buyers and sellers will be expanded. The logic of this reform, therefore, is to create a situation in which prices—whether state-controlled or not—will reflect their production cost and take into account the supply and demand forces in the economy. The Decision recognizes that this will lead to increased prices for some commodities and reductions for others, yet it makes clear that the reform will not be allowed to cause a generalized price increase. The message is that the price reform will be introduced gradually, and the various economic agents given time to adjust to the changes by altering their production or input mix, or by absorbing cost increases through productivity gains. To the extent that subsidies will be phased out and prices of previously subsidized goods increased, real incomes of consumers will be protected as wages and other income elements will be increased accordingly. The Decision also predicts that real wages will continue to increase, since the reforms will boost productivity gains. In these circumstances the

maintenance of price stability will greatly depend on the implementation of a monetary policy that prevents excessive liquidity growth in the economy.

The implementation of the price reform will be the most difficult element of the whole economic reform movement, since it will have an impact on all segments of economic activity. Financial flows will be affected, as will enterprise profitability, thus putting at risk the lines of production of some enterprises and the survival of others. Similarly, budgetary flows and sectoral credit requirements will be changed. The realization of this pervasive impact of the price reform on the economy explains the authorities' past reluctance to tackle this issue. There is an awareness now, however, that the benefits of the economic reforms will be jeopardized if the price structure is not altered, and this has prompted the authorities to accelerate the price reform.

Diversification of the economic structure. The widely recognized failure of the state and collective production sectors to respond effectively to market demand, to take sufficient advantage of the creativity of the work force, and to absorb growing numbers of people looking for employment led authorities not only to permit private activity to take place but also to stimulate such activities and clarify their scope. In the early years of the reforms, private sector activities were regarded with suspicion by some local authorities, who took arbitrary measures to prevent them from flourishing, but their contributions in providing new employment and new services have been gradually recognized. The number of private establishments has risen sharply in recent years, with these enterprises often absorbing graduates unable to find employment in state or collective enterprises. By the end of 1983 private establishments formed a still small, but rapidly growing, share of the total work force (about 2.3 million workers now, nearly a threefold increase since 1980). They are principally engaged in small-scale commerce, handicraft, catering, transport, and construction. Since early 1983 the private sector has been invited to lease small state-owned enterprises or to run them on a contract basis. As such, the role of the private sector is now firmly established in China, and its contribution is recognized as an irreplaceable element in the continued improvement of China's living standards.

Commerce. As recently as 1978 state and collective sectors accounted for 90 percent of total retail trade, thereby effectively monopolizing distribution channels. Production was largely insulated from distribution, and unsold inventories of some products and shortages of others were frequent. In addition, administrative barriers to trade between regions prevented the free flow of goods, and gave rise to costly local monopolies.

To alleviate these deficiencies, distribution channels were gradually diversified. Since 1979, private sector trade, virtually abolished during the "Cultural Revolution," has been revived and by 1983 it accounted for more than 18 percent of total retail sales and a much larger share of the trade in vegetables, eggs, handicrafts and small industrial commodities. Recent reforms streamlined regulations pertaining to private trade, spelling out registration requirements, tax obligations, and rights.

Efforts have been underway for several years to bring the productive sector more in line with the commercial sectors; these are intended to help producers gear their output more toward market demand. Commercial enterprises are being urged to purchase according to prior orders rather than stock all products that enterprises have to sell. Manufacturers have also been prompted to improve their market research and participate more actively in the work of the commercial sector in selling slow moving commodities. This may require discounts or the repurchase of defective products, both practices that have been extremely rare in the past.

Administrative barriers between jurisdictions and between urban and rural areas, erected when local self-sufficiency was at a premium, are gradually being abolished. These restrictions had given rise to a multitiered distribution system that prevented the rationalization of trade transactions, burdened administrative and transport facilities, contributed to the maintenance of excessive inventories, and promoted the existence of small, high-cost, regional producers. At present, experiments are under way to merge several levels of wholesale trade and to create an integrated supply network based on central cities, thereby unifying urban and rural markets. Progress has been slow, partly because of entrenched positions and interests but also because many jurisdictions want to protect their inefficient enterprises from the competition of outside producers.

In conclusion . . .

The process of economic reform now under way in China represents a very important development in China's history. It entails not only a realistic assessment of the development model of the past but also a commitment to safeguard the socialist nature of Chinese society while allowing resource allocation to be influenced increasingly by macroeconomic instruments, the forces of supply and demand, and material incentives. In the process, mandatory planning and administrative interference will be reduced.

This shift in gears initiated in 1978 has proceeded rapidly and produced good results in the rural areas; in the urban areas progress has been much slower, and the newest reforms focus attention on this sector. A "blueprint" of the type of economy Chinese authorities want to realize is now available. Its full implementation is still a long way off and a number of obstacles will have to be overcome. Some of these pertain to the manner in which enterprises will adapt to the changed economic environment. Although most of the problems have now been identified, practical solutions are still to be implemented. Other obstacles are more subtle, but may be more intractable. One will be to persuade an established bureaucracy, accustomed to taking nearly all production decisions, that it should relinquish some of its prerogatives, and allow decisions to be taken in a less structured manner and with a less predictable outcome. Another will be to adjust an economic philosophy that, for many years, has emphasized strict adherence to egalitarianism and job security rather than economic efficiency, without alienating the adherents of the previous approach. Furthermore, China recognizes that a successful implementation of the reforms will require further progress in giving greater responsibility to younger and better educated personnel and in accelerating managerial and financial training.

In the years ahead, Chinese leaders will have to steer the country over uncharted territory. While other countries have reformed their economy or are in the process of doing so, no other country has attempted economic reform on this scale affecting one billion people. Under its previous management system, China made considerable progress toward meeting the people's basic needs. Now it wants to do even better. F&D

Robert Townsend for F&D

Luc De Wulf
Belgian, is a senior economist in the Asian Department. He joined the Fund staff in 1972 and was desk officer for China for five years. A graduate of Louvain and Clark Universities, he has published on public finance.

Adjustment and reform in the Chongqing Clock and Watch Company, Sichuan Province, China

Here is an example of how one company responded to reforms in the period 1978–82. The Chongqing Clock and Watch Company (CCWC) was one of five state-owned companies chosen by Sichuan Province to participate in experimental reforms under the Four Modernizations Program. This gave the company some prominence in China's reform of light industry.

CCWC is one of the 12 largest producers of watches in China—a country where over half the urban residents own watches, and whose production and purchase of clocks and watches are unusually high for its per capita income level. The company started producing clocks in 1958, and began full-scale production of watches in 1977. By 1978, it employed 2,600 workers.

In the late 1970s, its output rose rapidly as a result of large investments financed by state grants. But the company suffered from shortages of capital, land, and labor (hiring of new workers being a highly restricted and tedious process); it had little authority to make decisions, and little incentive to expand production or to improve efficiency.

• **The reforms**. These were introduced mainly in 1980, and included:

1. Organizational changes, permitting joint ventures and various forms of association with other enterprises, which gave the company access to more resources, including land for expansion and increased its control over the production of parts and components.

2. CCWC was among the pioneers of a new incentive system replacing the remittance of profits to government with payments of income tax. From 1980 onward CCWC was allowed to retain 60 percent of its total net product, which it used for wages, bonuses, and various benefits to workers, and to invest in expansion.

3. Financing of fixed investment by bank loans and retained profits, rather than by grants from the budget. The terms of the loans were such that the enterprise bore very little of the financial risk of productive investment.

4. The end of guaranteed purchase by commercial units of all the company's output. Permission to market some of its output gave the company a strong reason to base its production decisions on forecasts of market demand. The company could not set its own output prices, however.

5. CCWC was authorized to plan its own production, investment, and investment financing, and could play a significant role in planning sales. It could contract directly with suppliers when its needs exceeded its input allocation quotas. Targets were still set by higher authorities for physical output of the company's main products, product quality, labor productivity, and profit. They were not rigidly enforced, however, and appear to have had little influence on the company's actual production.

6. Since 1978, the company has been allowed to pay bonuses for efficient work, but in other labor matters there was little change. Quotas largely unrelated to the production plan limited the number of workers the firm could hire, and redundant workers could not be dismissed. When several hundred were made redundant by the collapse of the clock market in 1982, the worst that happened was that groups of 300 workers at a time were placed on study leave, with temporary loss of bonuses.

These reforms and policy measures eliminated the most important constraints on CCWC's expansion of production. They also gave the company strong material incentives to increase production and profits. The company has allocated bonuses rather evenly among workers. However, a high proportion of its retained profits could be used to construct subsidized housing for its workers. Housing, which was in extremely short supply, was funded entirely by the company and allocated on the basis of seniority. This gave workers a strong incentive to raise the company's profits.

CCWC responded to the new opportunities with a highly ambitious expansion program supported by heavy borrowing. Gross output nearly tripled between 1979 and 1981. To a large extent, the company geared its decisions to the interests of workers and their dependents. Employment increased by 50 percent, while average annual wages per employee rose from 755 yuan to 950 yuan. The average value of nonproductive fixed assets per worker (mainly housing) more than tripled from 1979 to 1982.

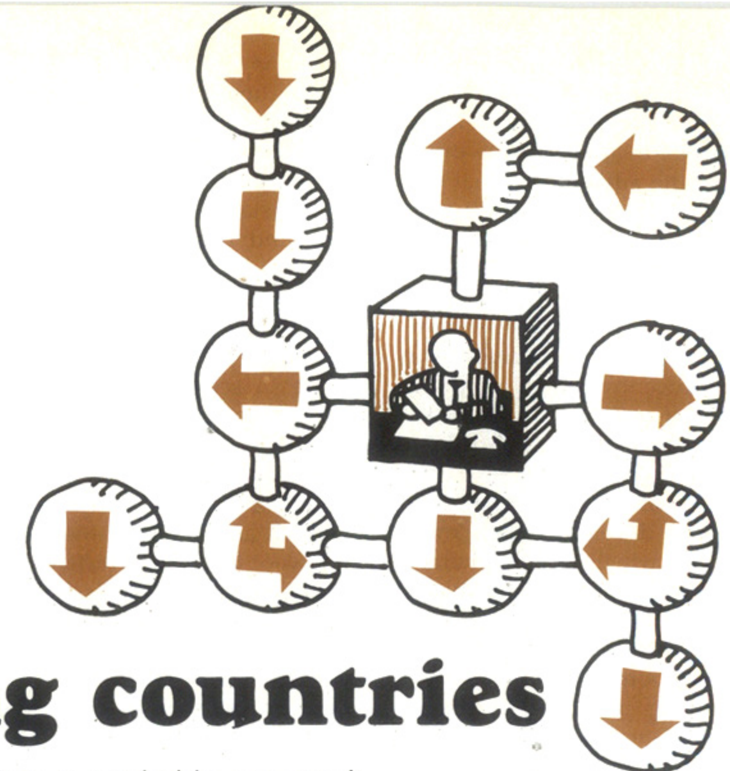
• **Marketing problems emerge**. By the end of 1981 the clock market had become saturated. And there were signs that watch producers, too, had overextended their capacity. National planning authorities intervened, limiting CCWC's targets for watch production to about half those planned by the company, and a reduction in watch prices imposed in April 1982 cut the firm's profit margins. At the end of 1981 CCWC began to have difficulty controlling the quality of its first-grade watches. In 1982, its clock production fell by 50 percent; watch production increased by only 10 percent; gross output rose by only 3.9 percent (compared with 66 percent in both 1980 and 1981); and total profits and retained profits fell by nearly one third.

The government's limitations on watch production and prices forced the company to confront more abruptly a marketing problem that was bound to emerge eventually. Despite this problem—the bane of consumer durables producers worldwide—the company had been left with strong financial incentives. It reacted by changing its development strategy from expansion of existing products to the development of new products and improvements in quality.

• **A change in strategy**. The change was accomplished through: (1) Selective adherence to the rules restricting the company's actions and affecting incentives. It seems likely that in this regard the company received special consideration by virtue of its prominence in the reform program. (2) Vigorously promoting sales. The most extreme example occurred in 1983, when several hundred clock production workers were forced to go out and sell clocks to avoid losing their bonuses and part of their wage. (3) Developing new products and varieties (including a washing machine timer and a gold-plated watch). On the whole, the company has been more successful in diversifying watch production than in finding new products to replace clocks. (4) Price reductions. Where possible, CCWC cut prices directly. Cuts in watch prices were forbidden because, being highly profitable and highly taxed, watch sales helped to maintain government revenue. Here the company disguised price reductions by changing the product mix and improving the quality of each grade of watch.

• **Conclusions**. CCWC's development in the past few years exemplifies how an enterprise can make the transition from extensive growth (by expanding the volume of output) to intensive growth (largely by widening the variety of its products and improving their quality). Promoting this transition is the underlying goal of China's economic reforms. In CCWC's case, the transition was accomplished in response to a mixture of reform in incentives, changes in market conditions, and direct government intervention that hastened the action of underlying market forces.

Based on a paper of the same title by William Byrd and Gene Tidrick in Recent Chinese Economic Reforms: Studies of Two Industrial Enterprises, *World Bank Staff Working Paper No 652, price $8, obtainable from World Bank Publications, P.O. Box 37525, Washington, DC 20013, USA. The paper is one of the first products of a collaborative research project between the Institute of Economics of the Chinese Academy of Social Sciences and the World Bank on enterprise guidance in China.*



Planning in developing countries

Using the lessons of experience to formulate a workable approach

Ramgopal Agarwala

During the last 30 years, most developing countries have attempted to accelerate growth through national economic planning. Since 1950 they have formulated more than 300 plans, varying somewhat in intentions and enormously in achievements. Although a neat and precise classification of these is obviously difficult to derive, they can be divided into three broad types. The first is the comprehensive planning approach, which has been strongly influenced by the Soviet example and has been attempted widely in Asia, eastern Europe, and northern Africa. The second is the indicative planning approach, which has been strongly influenced by the Western European experience in the postwar period and has been attempted in Southeast Asia as well as in parts of Africa. The third type of plan is largely formal (even ritual) and is typical of sub-Saharan Africa and Latin America, where planning was largely inspired by external assistance agencies.

Comprehensive planning

Almost all the socialist economies of Europe and Asia drew their inspiration for planning from the U.S.S.R. Initially, their emphasis was on achieving centrally planned material balances of inputs and outputs and allocating them among firms. However, problems with such planning accumulated, and countries switched to varying degrees of allocation via markets and prices. Yugoslavia started the process in the 1950s, Hungary followed in the 1960s, and China in the late 1970s. In recent years, even the U.S.S.R. has been moving away from its earlier emphasis on material balances and administrative allocations.

Among mixed economies, India was a pioneer in development planning. Even before independence in 1947, the Indian National Congress Party had formed a planning committee, which produced several unofficial plans. The colonial government also set up a Planning and Development Department, which published a 5-year plan and a 15-year perspective plan. After independence, planning was taken up with all seriousness. Prime Minister Jawaharlal Nehru was an ardent advocate of planning for the modernization of India. P.C. Mahalanobis and P. Pant were the key figures in developing the techniques of planning, particularly in the areas of heavy industries and sectoral balances; they and several other officials visited the U.S.S.R. to learn from its experience.

The approach was global and *dirigiste*. The objective was to manage national resources—both public and private—to meet the national objectives of growth and minimum consumption needs. Interindustry analysis was used to determine sectoral investment allocations and output targets. Administrative fiats were used not only to direct resources as desired but also to divert resources from low priority activities through a detailed system of licensing and production quotas.

In practice, of course, the vision of planners could not be fully implemented, but the reasons were not recognized for what they were—inherent weaknesses of the "blueprint" approach. Planners thought that with greater technical sophistication and administrative and political will, planned allocation would be feasible. Indeed, despite some ups and downs, the basic confidence in comprehensive and *dirigiste* planning continued in India until the 1970s. Only recently has there been some move toward allowing a greater role for markets and prices in the allocation of resources.

Neither Pakistan nor Turkey laid much emphasis on planning in the 1950s. Their economic performance in that period was poor and was perceived to be partly due to the absence of plans. As a result, the 1960s witnessed a surge of planning; both countries followed the centrally planned approach but greater use of prices was permitted than in India. In the face of the economic difficulties of the 1970s, however, both countries moved away from central planning and placed even more emphasis on prices and markets.

The more comprehensive study on which this article is based is published by the World Bank, under the title Planning in Developing Countries: Lessons of Experience, *as Staff Working Paper No. 576. Copies are $3 and can be ordered from World Bank Publications, P. O. Box 37525, Washington, DC 20013 USA.*

Bangladesh, on the other hand, started with tremendous political enthusiasm for central planning, backed by a considerable technocratic capacity to apply it. However, partly because of the adverse external environment, its First Plan (1973–1978) was largely a failure, a dramatic demonstration of the inherent political, technical, and administrative weaknesses of this type of planning in a poor and aid-dependent economy. In the ensuing years, Bangladesh has switched to concentrating on planning in key sectors, such as food, and to making greater use of markets and prices elsewhere.

The East Asian economies of Japan, Korea, and Singapore developed their own brand of planning, which can be characterized as comprehensive cooperative planning. As in South Asia, the approach was geared to managing national resources—thus the focus was comprehensive. However, the Confucian traditions of these countries allowed them to develop a unique approach combining partnership with pragmatism. The private sector and government designed long-term strategies as well as short-term action programs on the basis of consultation and cooperation. With fewer postcolonial inhibitions than South Asia, these countries managed to be pragmatic about the role of prices, the private sector, and foreigners. Their plans were characterized not by technical sophistication or strict adherence to targets, but by consultations and flexibility.

Indicative and formal planning

In Southeast Asia—Indonesia, Malaysia, the Philippines and Thailand—planning was weaker than in South or East Asia. The Colombo Plan initiated in the early 1960s and the international aid agencies provided the initial incentive for planning. Plans were geared more to macroeconomic balances than to sectoral consistency. Adherence to plans was weak, not only because of inadequate political and administrative support but also because of the readiness to adjust to changing circumstances. The indicative planning approach also influenced the francophone countries of Africa.

In much of sub-Saharan Africa and the Caribbean, planning was largely foreign-inspired and often managed by expatriates. In several former colonies of the United Kingdom—Ghana and Tanzania were particular examples—the colonial administration had formulated development plans before World War II. During the war, many colonial governments were, of necessity, doing some planning to allocate scarce resources. After the war, the socialist government in the United Kingdom insisted on plans under its Colonial Development and Welfare Act of 1945. Bilateral as well as multilateral aid agencies not only encouraged planning but also provided technical assistance for preparing the plans. France and Belgium also formulated development plans for their colonies and provided technical assistance for plan preparation after independence.

By and large, these plans were comprehensive in scope, yet indicative in their economic targets—apart from those for government expenditure, which were directive. Even so, the political support for planning was weak—except in a few countries such as Botswana and Malawi—and plans were largely ineffective. In addition to the inherent weaknesses of centrally directed planning that are discussed below, most African and Caribbean countries had a weak data base, a shortage of planning expertise, and weak administrations.

Latin America was the slowest region to embrace formal planning and to publish any plans. The import substitution strategy inspired by Raul Prebisch (and the Economic Commission for Latin America) was the core of their development effort. More attention seemed to be paid to sectoral and project planning and less to central planning than in Asia. The ECLA was a strong proponent of planning but made little headway. It was only with the launching of the Alliance for Progress in 1961 that most countries elaborated formal plans to qualify for aid. The consensus is that plans in Latin America had very little influence on economic decision making; in fact, Mexico, whose economic performance in the 1950s and the 1960s was among the best in Latin America, did not have any plans at all.

Experience

The degree of success achieved by planning is extremely difficult to assess. Planning has many purposes—some stated, some unstated. To the extent that plans aimed to mobilize aid, they served their purpose well, even if the programs were not implemented nor targets reached. To the extent that plans also served as an instrument for mobilizing public support for national goals, providing interministerial coordination on policies and programs, and putting greater emphasis on economic analysis, the *process* of planning itself was sometimes effective, irrespective of what happened to the implementation of the plan. Sometimes, too, plans were geared to defining a broad strategy (a "vision") and had no detailed implementation schedule, leaving the details of action programs to be determined as the situation unfolded. Similarly, the fact that targets were not reached does not necessarily indicate failure because changed circumstances might have made the departure desirable. In fact, in the successful cases of development, such as Japan and Korea, plans were neither detailed nor rigidly adhered to. Strictly speaking, the only valid criterion for judging the impact of plans is whether performance would have been better or worse in the absence of plans, and that is obviously difficult to assess.

Although the impact of planning cannot be fully assessed, the growing disillusionment with it, particularly with comprehensive *dirigiste* planning, is noteworthy. In many cases, plan targets have been exceeded, but often plans failed to achieve balance even in key sectors such as power or transport. In general, the poor implementation of plans has also clearly undermined their credibility even as an instrument for mobilizing political support. Also, by its nature, planning introduced certain biases—in favor of overambitious goals, overinvestment by the public sector, in large or new projects, and in administrative fiats. In many cases these biases proved costly.

A review of the experience of the 1970s reveals that the best performers were neither the countries that attempted comprehensive, *dirigiste*, planning (such as Bangladesh, Ethiopia, India, Sri Lanka, and Turkey) nor those (such as Argentina, Chile, Ghana, Jamaica, and Nigeria) that paid little attention to planning. Rather, the countries that performed best (such as Korea, Malawi, Malaysia, Colombia, Ivory Coast, and Kenya) by and large relied on streamlining incentives for guiding the private sector, but also provided a macroplanning framework for their public investment programs.

The literature on planning has dealt with various problems of comprehensive Soviet-style planning, particularly those arising at an early stage of development. Typical difficulties are a weak data base, a shortage of well-trained staff, inadequate cooperation from other ministries, and poor links with budgeting and evaluation processes. With additional resources, these problems can be alleviated over time. More serious are three types of fundamental problems—technical, political, and administrative.

Experience has revealed the inherent limitations of the technocratic central planning blueprint in a rapidly changing environment. Available analytical techniques are just not able to cope with the complexity of economic change and produce plans that are continually up-to-date, relevant, and comprehensive. Investment planning based on input-output models has fallen foul of unforeseen changes in technical co-efficients and demand patterns. Simi-

larly, manpower forecasting has been highly inaccurate because of the difficulties in specifying particular types of skills and in projecting demand for them over a long period and neglect of labor *market* analysis in these plans. These fundamental weaknesses are unlikely to be cured by any foreseeable improvement in data or analytical techniques. Obsession with efforts to improve comprehensive programming capacity diverts attention from its inherent weaknesses and resources from more practical uses of economic policymaking. The alternative approach to growth that makes greater use of markets and prices generates less formidable technocratic problems and, as experience shows, allows more efficient adjustment.

From a political point of view, the problem with central planning is that it constrains the economic choices that the politicians see as their prerogative. The clarity and certainty sought by comprehensive plans conflict with the flexibility and vague goals that are often the lifeblood of politics. In the real world of politics, attempts to draw up a detailed blueprint risk confrontation with political interests and can easily become counterproductive.

There are also inherent administrative limitations to applying such blueprints. For one thing, in most developing countries, a great many economic decisions are made by the private sector and are outside the control of the administration. Even where the administration is effectively in control of the economy, the objectives of the plan are not always shared by the bureaucrats implementing it. Deliberate obstruction and distortion by bureaucrats—as individuals and as sectional groups pursuing their own interests—lead to bureaucratic failures that are even more serious than market failures.

Trends and lessons

As the limitations of planning—both circumstantial and inherent—have become clearer, many developing countries have moved away from comprehensive, *dirigiste*, plans. Particularly in the 1970s, when the world economy was subjected to severe shocks, the limitations of such planning became more and more obvious.

It is interesting to note that this trend is quite different from that visualized by earlier planners. For example, Albert Waterston concluded from an early (1965) review of the planning experience that plans would evolve according to natural stages that mirror the stages of development—first, plans concentrate on project preparation in the early phase of development; next, they develop public investment programs as the government sector develops; and eventually they become comprehensive to include the emerging private sector. Another assumption of the 1960s was that implementation needed greater attention than the formulation of plans. Experience, however, seems to have followed a different path. Countries such as Korea and India have moved away from comprehensive, *dirigiste*, planning despite their higher stage of development and increasing technical expertise. Moreover, successful cases of development—such as Korea and Japan—are distinguished by the flexibility of their planning, which suggests that strict adherence to plans may not be a virtue in a changing situation. There is a growing realization among developing countries of the limitations of econometrics as an analytical tool, and a growing appreciation of the power of prices and markets, and of the importance of consultations, selectivity, flexibility, and coordination.

Incentives. A key lesson from the experience with planning is that the future is unknown and largely unknowable; planners should try to forecast what is necessary for decisions today. One important aspect of policymaking that does not require forecasting, but that can have large benefits in terms of efficiency, is streamlining incentive systems. There is strong evidence to suggest that policies leading to high distortions in prices and incentives also lead to significant losses in growth and do not necessarily produce benefits in terms of equity. More specifically, developing countries with relatively high growth rates have, in varying degrees, avoided major appreciation of the real effective exchange rate; kept the effective protection rate of manufacturing relatively low (below 40 percent) and fairly even among products; avoided the high taxation of agriculture that would result from holding down producer prices; kept interest rates positive in real terms and avoided real wage increases not justified by rising productivity; applied cost recovery principles in the pricing of infrastructure services; and avoided high and accelerating inflation.

The evidence of the 1960s and 1970s strongly suggests that nothing is more critical for economic progress than the skillful management of this interconnected system of prices and incentives. Many recent plans do, in fact, give much greater attention to prices and markets. For example, Korea's Fifth Plan (1982–86) makes the greater use of markets and prices its central focus. Plan projections—even of exports—are treated not as targets, but as forecasts, indicative of planners' best judgments. India's Sixth Plan (1981–85) has an extensive discussion on price policy.

Public investment. Appropriate prices help in the efficient allocation and utilization of resources in both the private and public sectors. However, governments do need to plan public investment carefully and in detail. To ensure the effective planning of public investment and to give guidance to the private sector, countries must rely to a certain extent on medium- and long-term forecasting. The art here lies in identifying the critical minimum level of forecasting necessary for these purposes. Most important, the variables, such as GDP, savings, investment, public revenue, public expenditure, exports, imports, foreign capital inflows, and so on, need to be projected to provide an informed macroeconomic and financial framework for decision making. As far as sectors are concerned, forecasts in a few key areas such as power, transport, and energy are more useful than detailed forecasts of sectoral and subsectoral outputs and investments. In particular, extensive medium-term targeting of outputs and investments has not proved useful. The emerging trends point to a need for combining the programming of public investment with forecasting (*not* targeting) for the private sector.

Experience suggests that many developing countries need to change the approach to the programming of public investment programs. The typical comprehensive planning approach is to formulate medium- and long-term output targets, work out the investment requirements for meeting them, and then to decide which sectoral investments should be undertaken by the public sector. Many countries have found, however, that the planners' knowledge of sectoral relationships between investment and output and of the time-lags involved is so limited that these exercises are of little value in practical decision making.

In many countries, a key issue for the 1980s is how to streamline completed and ongoing projects rather than how to design new investment programs. A recent survey by the World Bank showed that six out of every ten Bank borrowers have serious problems with underfunded ongoing projects and inadequate maintenance of completed projects. Tackling these problems requires a case-by-case approach very different from the earlier investment programming approach (as illustrated by the recent experience with public investment programs in Turkey). This approach concentrates on getting the best returns from completed and ongoing projects and identifying the "free" public sector resources available after budgeting for their legitimate needs. It also puts greater emphasis on performance auditing of completed and ongoing projects.

Calculations of resources remaining after the needs of ongoing and completed projects have been met would no doubt show that in most developing countries the amount of public resources available for initiating new projects is far short of the costs of projects being proposed by various public sector agencies. Thus the role of the planning agency is often to "shoot down bad projects"; consequently, strengthening the project appraisal capacity has become more important than the overall investment programming capacity. In this respect, calculations of rates of return (with shadow prices where appropriate) are more useful than the analysis of sectoral demand-supply balances, except in a limited number of cases where market failures are demonstrably important.

A workable approach

Whether the aim is to formulate the right incentives or sound public investment programs, close consultation among the concerned agencies is vital. Given the complexity of development problems, analytical techniques alone generally do not provide optimal solutions; qualitative judgment is essential, and sound judgment is most likely to emerge from consultation, not only among different parts of the government but also with businessmen and academics. Brazil, Japan, and Korea have, for some time, employed consultation to improve their economic management. To be effective, such a process should remain consultative and should not require conformity. Its aims should be primarily to share information and build consensus. An interesting case is that of Yugoslavia, where planners have attempted to improve the coordination of investment decisions *ex ante* by facilitating the exchange of information on the consistency of assumptions and by merely strengthening eventual contractual agreements.

The experience of the 1970s has also shown that even the best-laid policies and programs can be outdated by changing circumstances, and that the "learning approach" is more effective than any blueprint for national economic management. Flexibility is therefore essential for sound management. To assist in the process of adjustment, several countries (such as Bangladesh) have found it useful to identify a core program of high priority investment so that, in cases of resource shortfalls, program cuts can be selective rather than across-the-board. Rolling plans of public investment (such as those instituted in Botswana and Korea) also help in keeping the programs up to date.

Reconciling consultation with flexibility is not easy; consultations take time, and flexibility requires quick response. Two rules of thumb may be helpful in reconciling these requirements. First, governments need to be selective in the goals and key instruments they emphasize. Theoretically, everything depends on everything else and a comprehensive approach is intellectually attractive. Not all policies can, however, be determined at the same time, and selectivity is essential, even though it is often based on judgment. This approach has already been adopted in many countries: in Japan, both the national plans and the "visions" of the Ministry of International Trade and Industry have concentrated on selected themes; in Korea, export promotion has been a focal point for the development effort; in Bangladesh, planning was improved when it was directed at key issues such as increasing food production; in Malaysia, improvement in income and wealth distribution between Malays and non-Malays has been the central theme for the past ten years; in mineral-based economies such as Botswana, planning has concentrated on trying to convert mineral wealth into human and physical capital, while minimizing the adverse side effects on the rest of the economy; and in Kenya, the practice of preparing sessional papers (white papers) on key issues has proved useful.

Second, to combine flexibility with consultation, countries may have to rely on a central authority for coordinating efforts. In Korea, planning, budgeting, and policy functions have been integrated under a Deputy Prime Minister, who is also the chairman of a policy committee consisting of various economic ministries. In Brazil and Japan, the finance and industry ministries have played an active part in coordinating policies. In Hungary, that role has been assumed by an economic policy committee. In both India and Pakistan, the policy review capacity has recently been strengthened in the planning agencies and in the office of the Prime Minister and the President. Although the specific arrangements depend upon the circumstances of each country, an authoritative coordinating agency is clearly desirable.

Michele Iannacci for F&D

Ramgopal Agarwala
from India, is Senior Adviser in the Special Office for African Affairs, and worked on the World Development Report 1983 *and the 1984 Bank report on sub-Saharan Africa. Educated in Calcutta and Manchester, he joined the Bank staff in 1971.*

Planning is concerned with where we want to go; however, that task cannot be accomplished successfully unless we know where we are and where we have been. Although the former task is intellectually stimulating and has engaged a great deal of attention from planners, plans cannot be relevant unless they are well grounded in facts. Thus, a strong information system is essential for all aspects of economic management. Systematic adjustments in policies and programs, necessary in a fast-changing world, are not possible without the reliable monitoring of current developments. As a rule, detailed information—especially about key performance indicators—brings bigger dividends for economic management than do sophisticated techniques of long-term forecasting.

Recent advances in microcomputers and associated software have revolutionized the opportunities for providing decision makers with the analysis of relevant data. Relatively inexpensive, portable, resilient, and easy to operate, microcomputers are suitable for work in rural areas and for middle and junior managers who have no special programming skills. The availability of a rapidly growing library of software tailored to special needs is also a critical factor. Before they can be fully exploited, however, accounting systems will have to be rationalized and appropriate indicators developed for program monitoring.

Conclusions

A review of 30 years of planning in developing countries shows there is a need for reorientation from comprehensive production planning to strategic policy planning. Experience suggests several conclusions. Greater emphasis should be put on streamlining the incentive system rather than on preparing long-term blueprints for development and targets for sectoral investments and outputs. There should be more focus on coordination and consultation—both within government and in the private sector—than on obtaining consistency through top-down technical exercises. More attention needs to be given to programming public investment than to detailing total national investment. Because of the complexity of the issues, countries must be selective and must focus on the key policy issues and public investment concerns. In view of the uncertainties of the 1980s and 1990s, developing countries must be able to respond quickly to changing circumstances by modifying their policies and programs accordingly. If the need for consultations and flexibility is to be met, a central authority should be given responsibility for coordinating economic policies. F&D

Editorial note: Exchange rate matters are within the purview of the Fund; under Article IV of the Fund Agreement, members have certain specific obligations in this regard. Appropriate exchange rate policies promote balance of payments viability and can be powerful instruments for economic stabilization. They have also certain important longer-term implications for economic development and this article, by a senior member of the Bank staff, examines the consequences of overvaluation.

Overvalued exchange rates and development

A statement, in seven propositions, of the negative link

Guy Pfeffermann

Exchange rates send powerful and pervasive signals. Output of a product increases when its price relative to that of other products goes up, and such an increase can be caused by changes in the exchange rate. It has been clearly established in the economic literature that—regardless of their geographic location or level of income—farmers react strongly to price incentives. For instance, this has been confirmed by recent surveys of the poorest farmers of the Andean Altiplano. The exchange rate affects the price of tradable goods (exportables and importables) and is thus of immediate relevance to farmers who will be influenced in deciding what part of their efforts is to be devoted to growing crops and what to other activities and, in the growing of crops, what part will be destined for the market and what is to be retained for their own consumption. The recent World Bank report on Africa (*Toward Sustained Development in Sub-Saharan Africa*) noted the importance of exchange rates: "...for many commodities Africa's market share has continued to fall. Realistic exchange rates are critical to reverse this trend." If price signals have so powerful an effect on the production decisions of farmers in the Altiplano and in Africa, they must, *a fortiori*, influence decisions by entrepreneurs in the nonagricultural sector of developing economies. The evidence is overwhelming that decisions to produce (what? how much? for which market?) and to consume (domestic products? imports?), as well as decisions to save and invest, are influenced by real exchange rates—that is, nominal exchange rates adjusted for relative rates of inflation. Hence exchange rates play a crucial part in economic growth.

Under current exchange arrangements countries are free to adopt the exchange rate system of their choice, that is, floating, pegging to another currency or to a basket of currencies, and so on. In some countries a flexible exchange rate policy is followed and overvaluation may be easier to avoid. But overvaluation can occur regardless of the exchange rate system in force.

Frequently domestic pressures result in inflation, reflected in wages and prices of domestic goods. Inflation can also be the result of many other causes such as commodity price booms or sudden increases in capital inflows. However, the nominal exchange rate is often not allowed to adjust fully to reflect the increased costs. As a result, the real rate appreciates. Since the new rate no longer is an equilibrium one, imports must be curbed and, to achieve this, the government is faced with a choice between reducing economic activity through restrictive monetary and fiscal policy, or establishing quantitative import controls. The first course, if pursued long enough, is clearly inimical to economic growth, while the second course, involving controls, leads to a misallocation of resources, as well as lower growth. A third option is to increase import duties sharply. This option is not used as frequently as quantitative import controls because the latter have a more predictable effect on the quantity of imports. Governments can, of course, step up borrowing or use reserves to finance the deficit and accommodate the appreciated exchange rate; but this becomes unsustainable after a time.

Overvaluation then, can lead to quantitative restrictions (such as import quotas), which will raise the cost of imports, or, if imports remain liberalized for any length of time, to an unsustainable balance of

payments deficit and an eventual real devaluation. In short, quantitative restrictions are the usual way in which overvaluation can be sustained for any length of time. Yet, when countries are able to borrow large amounts abroad, overvaluation can be sustained for months or even years, as was the case in Argentina, Chile, and Uruguay before the 1982 debt crises erupted. Moreover, powerful political pressures often build up in favor of overvaluation because of the benefits that accrue to particular groups (such as importers or consumers of imports). These benefits, as noted above, are temporary, but can last for a considerable period of time.

It is not easy to determine in practice at which point exchange rate appreciation becomes overvaluation. The notion of exchange rate equilibrium is elusive, especially when interest rates may be far from equilibrium. Equilibrium can only be defined in relation to some objective, for example the attainment of a particular growth rate of exports and GDP in the light of likely capital inflows. One practical danger signal is the loss in a country's share in world exports.

How does an overvalued exchange rate affect economic development? And why are governments often so reluctant to reestablish a realistic exchange rate? The remainder of this article addresses these questions in greater detail. The seven propositions that follow are meant to highlight some of the principal consequences of overvaluation, in particular as they affect development. The propositions are by no means exhaustive, and there is unavoidable overlap between several of them.

Proposition 1: overvalued exchange rates undermine exports. The importance of a dynamic export sector in the course of development is well recognized. To the extent overvaluation undermines export profitability and—in cases where the country affects prices—reduces other countries' incentive to import from the country with an overvalued rate, it strikes at the very core of the development process. Exports are not only vital where they represent a large share of total production and employment; they are also important because, in most countries, the availability of foreign exchange is one of the main determinants of the overall level of economic activity. Even where exports account for only a small portion of GDP, a shortfall in foreign exchange can slow growth for the entire economy. Indeed, it may be argued that countries that have gone farthest in import substitution, and have reduced the share of trade in GDP to the limit, are most vulnerable to foreign exchange shortages because imports can no longer be compressed in a crisis; *all* imports have become essential for maintaining output.

An overvalued exchange rate undermines incentives to produce not only exports but also import substitutes. This is because exports lose competitiveness and imports become relatively cheaper as a result of the overvaluation, provided no import restrictions have been imposed. Thus the production of *all* traded goods is undermined by an overvalued exchange rate.

Where quantitative import restrictions do exist, imports may not become relatively cheaper. In this situation, however, exports are further discriminated against because of the general inefficiencies and high costs associated with the quantitative import restrictions. Attempts to offset the anti-export bias through subsidies may prove unsustainable because they will widen the fiscal deficit.

By undermining export growth and diversification, overvaluation (with or without quantitative import restrictions) powerfully retards economic development.

Proposition 2: overvalued exchange rates harm agriculture. This point, leading on from Proposition 1, has been made often; a recent World Bank study of agricultural pricing policies in Mexico concludes that changes in the real exchange rate have, since 1960, had far more impact on agricultural incentives and output than any of the government's agricultural pricing policies. This is because the effect of the exchange rate was more pervasive than that of the price support mechanism, resulting in a decline in relative prices.

The effect of overvaluation on agriculture deserves special mention because in the early stages of development agriculture is the key sector and the largest source of employment in most developing countries. While industry often enjoys high protection, agriculture typically receives none (or in many cases even suffers from negative effective protection). Clearly, the implications of discrimination against agriculture are wide ranging.

First, the poorest people live in rural areas dependent on agriculture; therefore, discriminating against agriculture harms the poorest. Realistic exchange rates, on the other hand, are more conducive to rural prosperity and have a positive effect on income distribution as well as growth. Second, where the internal terms of trade are so biased against agriculture, fueling migration to the cities, the need for imported foodstuffs rises, and yet more pressure is put on the balance of payments. Third, inadequate agricultural incentives (relative to those in other activities) can have profoundly negative effects on development; there is a close association between agricultural performance and overall economic development, even in countries where agriculture represents only 5 or 10 percent of GDP. To the extent overvalued exchange rates hurt agriculture, they discourage overall development.

The argument can be extended to other resource-based activities. Overvalued exchange rates undermine incentives in forestry, mining, agro-industries, and basic industries. By making imports relatively cheaper, at least temporarily, overvaluation not only discriminates against the development of appropriate domestic technologies, it also, through cheaper imports of capital goods, encourages relatively capital-intensive methods of production, thus discouraging employment creation. Where governments have protected these sectors from foreign competition, this has led to high-cost (relatively small-scale) operations and, eventually, to a stagnation of output and employment. In both cases overvaluation undermines the potential for development of labor-intensive activities and promotes reliance on imported inputs.

Who benefits? Clearly, the perceived or real benefits accrue to the urban population through cheaper food. This, of course, like most of the other "advantages" of overvaluation, is true only so long as the rate can be maintained without quantitative restrictions.

Proposition 3: overvalued exchange rates stimulate imports. In general, overvaluation stimulates demand for foreign exchange as it is made relatively cheaper. This effect is compounded if the public believes that the government will not be able to maintain the rate for long and people buy more foreign exchange to take advantage of the relatively low price. Imports and tourism expenditures abroad will rise. Additional demand for foreign exchange will put pressure on reserves and increase borrowing requirements. Eventually overvaluation generates pressures for increased import controls and, as discussed below, competition for imports will shift from the economic to the political arena.

Who benefits? Unless importers are able to take advantage of the situation, cheaper imports benefit those who can buy them, reflecting the pattern of income distribution. The constituency favoring cheaper imports is an influential one; it includes the most affluent, and therefore often politically powerful, segment of the population, including those who have protected markets for their goods and want cheap inputs. Against this, there is the generally less influential constituency composed of farmers and exporters in general. One silent, but important, opposing group consists of *potential* exporters, who, because of

overvaluation, are unable to secure export markets. Another silent group is the unemployed, who would stand to gain from policies that accelerate long-term economic growth.

Proposition 4: overvalued exchange rates destabilize the capital account and often precipitate debt crises. Overvaluation (often a result of inconsistent underlying policies) exerts pressures on the current account of the balance of payments. These can be offset temporarily through compensating capital flows. A government may be able to step up borrowing to finance additional consumer goods imports. But in the face of increased borrowing requirements which reflect a steadily widening current account deficit—and, usually, declining domestic savings—the debt-servicing burden will increase, eventually leading to a crisis.

Some countries have tried to avoid this sequence of events by encouraging private capital inflows. This can be done in various ways, notably by creating incentives to borrow abroad where foreigners believe they stand to gain by lending to the country. As domestic prices increase faster than the currency depreciates, overvaluation of the currency increases; in this situation if domestic interest rates are attractive to domestic savers, they will be even more attractive to foreign savers. For example, if expected inflation in a country is 20 percent and domestic savers receive 10 percent real interest on their deposits, a constant nominal exchange rate translates into a 30 percent return to foreign savers who invest in the country for one year. The expectation of predictable future overvalued exchange rates in Chile, Argentina, and Uruguay during the early 1980s helped attract massive private capital inflows during these years.

A problem arises, however, as time elapses. If overvaluation persists and the public becomes increasingly aware that capital inflows are taking place while the trade balance is deteriorating, concerns will arise that the situation may not be sustainable. It is increasingly realized that interest payments are financed out of new external borrowing and, eventually, the public will be sufficiently worried about the future that expectations of a massive devaluation build up and prompt capital flight. The government may then step up its own external borrowing to protect reserves, further raising the debt-servicing burden. Eventually devaluation becomes unavoidable and causes severe problems for those who had incurred debt denominated in foreign currency. Experience has shown that private sector debt problems may persist for many years and that the social cost of dealing with debt crises is very heavy. Finally, once a country has gone through this sequence, expectations of further instability can easily develop and inhibit economic growth because such expectations are inimical to long-term productive investment and efficient resource allocation.

Who benefits? While "the going is good," overvaluation benefits those who are in a position to borrow cheaply abroad. Once a crisis seems imminent, those who participated in capital flight and invested their savings abroad will benefit.

Proposition 5: overvalued exchange rates breed protection against imports. This is another very obvious negative result of overvalued exchange rates. As noted earlier, overvaluation, by making imports relatively cheaper, generates pressures on the part of threatened (import-competing) industries for increased protection. If governments yield to such pressures, as they frequently do, the new protective structure is likely to be less conducive to efficient resource allocation than the earlier one, and inimical to growth. It may be argued that the inevitable, eventual, devaluation of the currency can be coupled with a reduction in tariffs and other protective measures (this is known as "compensated devaluation"); unfortunately it is often far easier for governments to modify the exchange rate than to change the protective structure, and the latter therefore tends to endure.

The protective structures that have existed in some developing countries for decades, erected partially in response to overvaluation, have in turn fostered chronic overvaluation. This is because, on the one hand, tariffs and quantitative import restrictions dampen demand for foreign exchange by raising the price of foreign goods and services; on the other, rationed access to foreign exchange translates into an exchange rate that is more overvalued than that which would have prevailed if the demand for foreign currency were not curbed by protection. The two are mutually reinforcing: overvaluation generates pressure for protection against imports; protection against imports perpetuates overvaluation.

Giuseppe Franchini for F&D

Guy Pfeffermann
a French citizen, attended the Universities of Strasbourg and Paris, and was Besse Scholar at St. Antony's College, Oxford. He joined the Bank staff in 1966 and is now Chief Economist, Latin America and the Caribbean Region.

Proposition 6: overvalued exchange rates do not help curb inflation. This is one of the major lessons of economic management during the last decade or so. Because overvaluation means that imports are relatively cheap, governments have often resorted to exchange rate policy in attempts to contain inflation. There are serious problems with this approach. First, while imports do represent a fair proportion of the cost of living "basket" in most developing countries, in many countries their weight is not large enough to make much of an impact on measured inflation. Second, even if overvalued exchange rates do manage to reduce inflation, the unavoidable ensuing devaluation will cause inflationary pressures that usually more than cancel the "benefits" of overvaluation.

Uruguay's experience is an interesting illustration of why overvaluation does not curb inflation. Throughout the period 1978–82 domestic inflation substantially exceeded the rate of devaluation adjusted for international inflation as (1) local prices of tradables continued to rise rapidly because the local marketing firms were able to capture the gains from cheaper imports, and because of continuing high protection of local manufacturing; (2) prices of nontradables rose rapidly, notably because of a speculative construction boom; and (3) interest rate arbitrage led to a large inflow of funds from abroad.

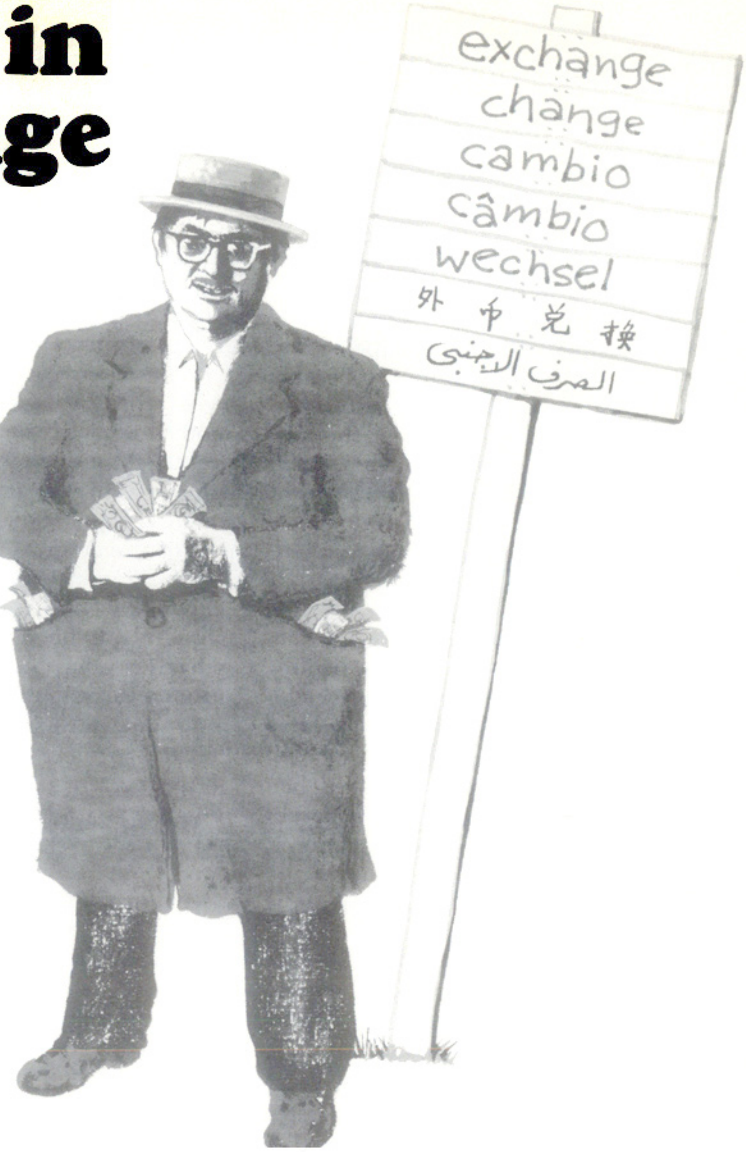
Who benefits? Again, so long as "the going is good," urban consumers benefit from whatever reduction in inflation may occur (because of adverse terms of trade farmers are not among the "beneficiaries").

Proposition 7: overvalued exchange rates promote rent-seeking economies. By breeding pressures for increased quantitative protection, overvaluation increases the rents (i.e., income that is generated because of an artificially created scarcity) of those with access to import licenses. The same is true for those who have access to (relatively cheap) foreign credits. Besides being less efficient and less conducive to growth, the rent-seeking economy encourages private gain at the expense of public welfare (under quantitative import restrictions, for example, the implicit tariff accrues to the importer, not the government). Corruption almost unavoidably flourishes in such a climate. More generally, overvaluation encourages the politicization of the economic process: the attainment of political power becomes vitally important from a private economic point of view, and this, in turn, fosters divisiveness between those who have political power and can extract rent, and the rest of the population.

Black markets in foreign exchange

Their causes, nature, and consequences

Michael Nowak



Exchange controls have frequently beei used by countries attempting to protec their international reserves in periods o balance of payments difficulties. Typically governments have viewed exchange con trols as a substitute (or at least as a tem porary stop-gap) for unpalatable adjust ment measures, even though controls dc nothing to address the underlying causes of external imbalance. Indeed, by aggra vating existing distortions in relative prices and resource allocation, controls may ex acerbate the very problems they were in tended to alleviate.

As with any type of restriction, exchange controls encourage evasion. When this happens in an organized manner, "black markets" in foreign exchange arise ("unofficial," "parallel," or "curb" have alsc been used as terms to describe this type oi market). Such markets are generally frowned upon by governments because they divert scarce foreign exchange from official channels to uses which the controls are trying to restrict. More important, black markets can affect the economy as a whole and have a number of important policy implications. These matters and other features of black markets in foreign exchange are discussed in this article.

Causes and extent

There are three options open to a country encountering balance of payments difficulties: adjustment measures using the instruments of fiscal, credit, incomes, and exchange rate policy; external borrowing; or imposition of controls on international trade and payments. The first option may have short-term consequences for income distribution, employment, or inflation that governments would like to minimize, while the second—recourse to borrowing—is generally limited in scope, expensive, and capable of providing only temporary relief. Quantitative controls, on the other hand, may appear to provide a solution which has immediate and direct effects but is less troublesome in terms of its social and economic costs. Not surprisingly, therefore, controls have frequently been used in response to external imbalances, particularly among developing economies. (A full description of the exchange control regimes of Fund members may be found in the IMF's *Annual Report on Exchange Arrangements and Exchange Restrictions.*)

When quantitative controls take the form of restrictions on the availability of foreign exchange through official channels, black markets in foreign exchange invariably develop. If a central bank is unable, or otherwise unwilling, to meet all the demand for foreign exchange at its official exchange rate, those whose demand is frustrated will be prepared to offer a price above the official rate, as long as the risks and costs of evading the exchange control regulations are not prohibitive. Faced with such offers, those who earn or borrow foreign exchange will have an incentive to sell on the black market rather than to the central bank.

The size of any black market in foreign exchange and the exchange rate premium it commands over the official market will depend upon the range of transactions subject to controls and the tightness with which they are applied. In countries where the central bank satisfies a large proportion of the prevailing demand for foreign exchange, the black market will tend to be thin and the black market exchange rate volatile. Conversely, in those countries which face chronic balance of payments pressures and have insufficient reserves or borrowing capacity to defend the official rate, black market activities are typically well developed and organized, with the price of foreign exchange as much as ten times higher than the official rate. In a number of countries, black market transactions are officially tolerated, though strictly speaking illegal; under such conditions, the exchange rate in the black market can

A more extended analysis of this topic by the author, Quantitative Controls and Unofficial Markets in Foreign Exchange: a Theoretical Framework, *has been published in IMF* Staff Papers, *June 1984.*

provide a fairly good indication of the extent to which the currency in the official market is overvalued.

Demand and supply

The sources of demand and supply of foreign exchange in a black market obviously depend very much on the characteristics of the country concerned as well as the exchange control regulations. As a general rule, outward capital transfers, invisible payments, and certain imports (particularly of consumer items) considered inessential will make up the bulk of the demand for foreign exchange in the black market, since these are the types of transactions most frequently subject to control in the official market. While central banks are usually prepared to sell foreign exchange to meet demand for imports such as basic foods, petroleum, and inputs for the export sector, in extreme cases where a country is facing particularly severe balance of payments pressures, these items, too, may be subject to restrictions, and foreign exchange demand to finance them will also tend to spill over into the black market.

Quantitative restrictions may constitute part of the formal exchange control machinery. Those who wish to purchase foreign exchange at the official rate can then obtain advance information of their entitlement from the general rules that apply; these may be in the form of quantitative limits on invisible payments, such as overseas travel, or they may comprise allocations for the purchase of specified imports. Frequently, however, restrictions arise in an ad hoc manner as a result of foreign exchange being withheld after authorization has been granted and payment has fallen due. These types of restrictions, known as payments arrears, have grown markedly in recent years with respect to both trade and debt obligations; they have had particularly damaging effects on the international credit standing of the countries concerned.

While commodity exports provide the bulk of foreign exchange earnings in most countries, proceeds from the smuggling abroad of export products will not necessarily account for a large part of the foreign exchange sold on the black market. Apart from commodities produced close to the frontier and involving relatively low transport costs, the black market is more likely to be fed from other sources of foreign exchange where evasion of the law is easier. Notable among these are sales of foreign exchange by tourists, diplomats, and foreign workers; remittances sent back by nationals resident abroad; and, perhaps most important of all, the overinvoicing or underinvoicing of trade documents.

Overinvoicing of imports (that is, overstating the value of an approved import) will allow an importer to obtain additional foreign exchange at the official rate, which he can resell at a profit in the black market. Similarly, an exporter who underinvoices (that is, understates the value of goods exported) can sell the unreported part of the value of his exports on the black market. In both these transactions, which frequently take place with the collusion of the external seller or buyer, the true price is misstated and foreign exchange is diverted away from the official market by the premium offered in the black market. (But it is not always the case that improper invoicing is a source of supply to the black market. For example, where import duties are high compared to the black market premium, it will be profitable to underinvoice imports and purchase the necessary balance of foreign currency in the black market. Likewise, there will be an incentive to overinvoice exports in instances where a relatively high export subsidy is provided.)

Black markets in foreign currency do not necessarily operate within the frontiers of the country concerned. There are many cases of unofficial transactions being handled in offshore locations, usually in a country which is a major source of foreign exchange. The obvious advantage offered by offshore transactions is the comparative ease with which exchange control regulations can be evaded.

Consequences

Were controls to be effectively implemented, they could provide protection against reserve loss, even though they would still fail to address the fundamental economic policy weaknesses that lie at the root of chronic balance of payments difficulties. Invariably, however, controls are evaded through improper invoicing of trade documents and other leakages arising from the spread between the official and black market exchange rates. As a consequence, a central bank may find itself faced with continuing pressures on its international reserves and a loss of firm control over the uses of foreign exchange it allocates. Exchange controls also have unintended consequences which may involve substantial social and economic costs. The most prevalent of these are inflationary effects, distortions caused in the pattern of resource allocation, and bureaucratic corruption. Each may be considered in turn.

In an economy where the central bank defends a fixed exchange rate without resort to exchange controls, reserve losses through the balance of payments will act as a brake on excessive monetary expansion. When controls are applied, this automatic mechanism limiting the build-up of inflationary pressures is no longer operative. While the prices of nontraded goods tend to rise as fast, if not faster, than the prevailing rate of inflation, the prices of traded goods will be held down by conditions in international markets and the official exchange rate. The resulting decline in the price of traded, relative to nontraded, goods will encourage, on the one hand, a reallocation of resources away from production of exports and import substitutes and, on the other, a shift in consumer preferences in favor of imports. The consequence will be an oversupply of those goods which do not generate or save foreign exchange and an insufficient supply of those that do. This suboptimal pattern of production and consumption will involve a real cost to the economy and a loss of national income and welfare. Furthermore, without corrective policy action, the distortions in relative prices resulting from the controls will tend to grow increasingly acute over time.

To the degree, therefore, that black market activities circumvent foreign exchange controls, they may fulfill a useful function in the sense that they mitigate the adverse repercussions of quantitative restrictions on the allocation of resources. They provide exporters who do not sell foreign currency to the official market with increased prices and allow importers to purchase goods which they could not otherwise obtain at prices they are willing to pay. In this way, the black market provides a mechanism by which the domestic currency effectively undergoes a depreciation in its external value, while the official rate is fixed.

The application of exchange controls entails the rationing of scarce resources through means other than the price mechanism. As a general rule, this rationing will take place in accordance with established economic and social priorities, as embodied in the regulations governing exchange control procedures. But, in spite of this, officials of central banks or government departments invariably find themselves with discretionary powers to allocate foreign exchange. This may be because the exchange control regulations are not being strictly adhered to or, more usually, because the regulations themselves allow foreign exchange approval to be granted in a discretionary manner. This is particularly true for those foreign exchange approvals typically made on a case-by-case basis, such as those for nonessential imports, payments of arrears, and various invisible payments, including education and medical expenses.

The danger then arises that decisions made by officials in such "gray areas" not clearly defined by exchange control regulations will be influenced by the potential profits to be made by exploiting the exchange rate differential between the official and black markets. This differential places a premium on gaining access to the official market and thus exposes the officials responsible for making foreign exchange allocations to an environment conducive to corruption. Indeed, the political leverage of those groups with vested financial interests in the maintenance of controls may account for the reluctance of some governments to dismantle them.

Some policy considerations

If indeed black market activities do temper some of the harmful consequences of quantitative restrictions, then measures aimed at repressing these activities (such as stricter enforcement of exchange control laws and harsher penalties) would serve only to make matters worse. On the other hand, liberalizing exchange and trade restrictions in the face of continuing balance of payments pressures is likely to lead to the exhaustion of reserves and the emergence of new arrears. If external balance is to be restored without renewed resort to controls, the adjustment process will usually require policies to curb the growth of domestic expenditures and encourage a transfer of resources to the traded goods sector.

It is in the area of exchange rate policy that governments have, in general, shown most reluctance to undertake corrective action in addressing balance of payments problems, even when there are clear indications that the currency in the official market is grossly overvalued. To some extent, this is attributable to pressures from interest groups anxious to maintain the existing distribution of income. In addition, though, the reluctance of governments to undertake a devaluation reflects concern over the effects on prices and real wages. Such concern is not necessarily warranted.

• ***Devaluation and inflation***. For economies with exchange controls in place, the adverse short-term impact on prices and real wages normally associated with a devaluation will already have been partially felt as a result of the depreciation of the currency in the black market. Once the official rate is devalued, the extent to which the domestic price and cost structure adjusts may be limited, if not negligible. The actual magnitude of the direct impact on prices will depend on the response of the exchange rate in the black market and on the size of this market relative to the official market. Devaluation will also affect domestic prices through indirect effects on the money supply and output.

A devaluation of the official exchange rate raises the domestic currency price of officially traded goods relative to that of nontraded goods, and thereby provides an incentive to increase domestic production of exports and import substitutes. The resulting increase in the country's overall foreign exchange earnings will cause, other things given, an appreciation of domestic currency in the black market, even though sales to the black market may contract. In theory, therefore, one would expect the prices of imports purchased on the black market to decline when the official rate is devalued. When a relatively large proportion of the economy's foreign exchange transactions are conducted on the black market, a devaluation of the official rate could have a significant deflationary impact on consumer prices.

In practice, however, one might not observe, in the short run at least, an appreciation of the domestic currency in the black market following a devaluation. For a number of export commodities, particularly agricultural products, it may take some time for production, and thus the supply of foreign exchange, to respond to favorable shifts in relative prices. Moreover, in cases where export activities are dominated by foreign-owned enterprises, the amount of foreign exchange brought into the country by them in order to cover local production costs (which are fixed in terms of domestic currency) will fall as a result of a devaluation and this could cause the black market rate to depreciate. Another factor affecting the relationship between the black and official market exchange rates concerns the role of expectations. If a devaluation was widely anticipated, the black market rate will have adjusted in advance as a result of speculative activity. The direction of the movement in the black market rate at the time of the devaluation will then depend on the size of the devaluation, compared with initial expectations; if it turns out to be less than expected, there will be a tendency for the black market rate to decline. If the underlying rate of currency depreciation is substantial, because for example, the domestic inflation rate is substantially greater than that prevailing externally, this could mask any appreciation of the black market rate that may take place as a result of a change in the official rate.

In any event, even though the black market rate may depreciate following a devaluation, it is most improbable that the exchange rate premium on the black market will rise. Hence, solely in terms of the direct price effects, one could safely argue that a devaluation will be less inflationary when there is a black market than when there is not. The inflationary impact associated with the imposition of controls will, of course, already have taken place.

A devaluation may also set in motion deflationary forces through its impact on the money supply and output. For example, a devaluation which is undertaken in the context of an economic adjustment program will generally involve external financing additional to that which the country in question might normally obtain. While such financing will allow some replenishment of reserves, it will also permit a liberalization of the exchange control regime and an increased flow of imports of goods and services. This will help contain any inflationary pressures resulting from the direct price impact of a devaluation. In addition, excessive monetary expansion may be curbed by a widening of the tax base following a devaluation, although the overall effect on the central government's borrowing requirement will, of course, depend also on the response of expenditures.

• ***A measure of overvaluation?*** Under certain conditions, the black market rate can provide useful information on the extent to which the domestic currency has become overvalued in the official market and on the size of the devaluation required to restore an equilibrium rate. If the argument that a devaluation of the official rate will lead to an appreciation of the black market rate is correct, one can infer that the official rate would not have to be adjusted fully to the level of the black rate in order to bring about a reunification of the two rates.

Caution should, however, be exercised in making such judgments since, in some instances, restoration of external equilibrium may require that the official rate be depreciated by more than the prevailing exchange rate premium in the black market. For example, the black rate may be more appreciated than the equilibrium rate if the central bank is selling foreign reserves (running a balance of payments deficit), or if the costs of undertaking illegal transactions on the black market are large and if they affect the buyers of foreign exchange more

Robert Townsend for F&D

Michael Nowak
a British citizen, was educated at the Universities of Manchester and Western Ontario. He has worked for the Reserve Bank of Australia and Forex Research Ltd. and is currently in the Fund's Exchange and Trade Relations Department.

than the suppliers. Use of the black market rate as an indicator of the overvaluation of the official rate must, therefore, be supplemented by other indicators of disequilibrium, such as real effective exchange rate indices and medium-term balance of payments estimates. (See "Determining the appropriate exchange rate in LDCs," by A.H. Mansur, *Finance & Development*, December 1984.)

• ***Transitional arrangements.*** In the process of liberalizing exchange and trade controls, a number of countries have adopted transitional arrangements involving multiple exchange markets designed to spread the costs of adjustment over time. The transitional arrangements often legalize the existing black market and erect formal controls for delineating transactions between the two markets. Not infrequently, however, legalization of the black market is accompanied by new restrictions on demand that result in the emergence of an illegal third market. Sometimes these restrictions are not applied formally through exchange control regulations but arise in an ad hoc manner because the exchange rate in the secondary market is fixed and the central bank is unable to meet all the prevailing demand for foreign exchange from its reserves.

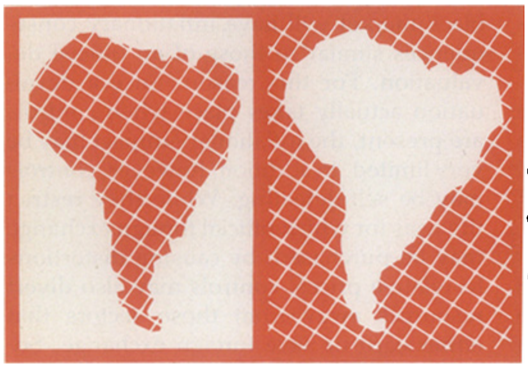
While transitional arrangements apply, the community as a whole would benefit if the government were to appropriate the profits that accrue to those individuals who are able to obtain access to the relatively cheap foreign exchange in the official market. While eliminating controls and levying a tax on imports and invisible payments is one possible way of achieving this, it is not usually particularly appealing to central banks because they lose direct control over the amount of foreign exchange sold. One method of appropriating the rent, but still allowing the central bank to retain quantitative control over its reserves, is to auction the available pool of foreign exchange. This is equivalent to a tax with a variable rate assessed on the difference between the official exchange rate and the auction price. Schemes to auction import licenses yield the same benefits.

The actual reunification of the two foreign exchange markets can be achieved through progressive devaluations of the official rate and the phased transfer of transactions from the official to the secondary market. It is important that this transitional process be undertaken fairly rapidly, so that any initial improvement in relative prices in favor of the traded goods sector is not eroded.

In conclusion . . .

When confronted with balance of payments difficulties, policymakers frequently resort to imposing exchange and trade controls as a means of providing protection against reserve loss. Other forms of remedial action, in particular devaluation, are often avoided for fear of kindling inflationary pressures and lowering real incomes. This article has argued that controls are a poor substitute for devaluation and complementary demand management policies. When controls are imposed, the resulting depreciation of the currency in the black market will have inflationary consequences similar to those of an official devaluation. For this reason, once a devaluation actually takes place when controls are present, the inflationary impact may be very limited. In addition, however, controls may be self-defeating. While they restrict the uses for which official foreign exchange may be purchased, by causing distortions to relative prices, controls may also divert resources away from those sectors that either earn or save foreign exchange. Society as a whole is generally made worse off as a result of controls, but substantial benefits may still accrue to those groups with privileged access to subsidized foreign exchange in the official market. In many instances, the political leverage applied by such groups intent on safeguarding their vested interests provides further resistance to devaluation, even in the face of chronic foreign exchange shortages. FD

Editorial note: If energy prices and inflation were the principal economic issues of the 1970s, there is little doubt that external debt difficulties have dominated the first part of the 1980s. Debt crises are not only an issue for the debtor developing countries, they have also posed serious problems for the international financial system as a whole. In recognition of this, *Finance & Development* has, in the past two years, devoted considerable space to external debt matters. The two articles in this issue deal with two key aspects of the debt question.



Domestic and external causes of the Latin American debt crisis

Many factors contributed, but inadequate policies were crucial

Eduardo Wiesner

A careful analysis of economic data and the policies that most Latin American countries followed over the past five or six years clearly shows that the region's external debt crisis stems from two basic sets of causes. First, following the emergence of external imbalances that required internal adjustment measures, countries sought to avoid reducing total public and private expenditure to the level of available resources; and second, loans from international commercial banks and other lenders—both public and private—expanded at an extremely rapid rate. These factors are closely interrelated, but for purposes of analysis a clear distinction must be drawn between the first set of causes, originating domestically from national economic policies, and the second, of external origin and related primarily to international commercial bank financing.

Gravity of the debt problem

Before analyzing the factors mentioned above, it is important to recognize the scope and magnitude of the Latin American debt problem, and the fact that it is not a temporary crisis linked to a particular phase of the business cycle. On the contrary, it will take many years before most of the countries return to a normal situation in which markets resume their role as principal regulators of financial flows and international trade.

There is no single criterion by which to measure external debt or determine whether a given level of indebtedness may be considered excessive or reasonable, and there are considerable problems of definition and measurement. Nevertheless, in the case of Latin America, even though the gravity of the debt problems was not uniform among all countries, it seems abundantly clear that we have been faced with an unprecedented crisis, regardless of the indicator used. For instance, in 1983 the stock of external debt was equivalent to 120 percent of GDP in Costa Rica, 103 percent in Chile, 76 percent in Peru, 66 percent in Argentina, 63 percent in Uruguay, 47 percent in Venezuela, and 44 percent in both Mexico and Brazil.

It may be argued that it is not the size of the debt, either in absolute terms or relative to GDP, that matters but whether it can be serviced; this would imply a comparison of debt-service obligations (payments of principal and interest) with exports of goods and services. The resulting picture is no less dramatic: Brazil, for instance, would have required 89 percent of its exports of goods and services in 1982 to service its external debt; Argentina, 68 percent; Ecuador, 69 percent; Chile, 65 percent; and Mexico, 57 percent. Even if the assumption is made that debt principal is not normally repaid, but refinanced, the situation would still be very serious. In 1983 Argentina would have needed to earmark 54 percent of its exports of goods and services to pay the interest on its external debt; Brazil would have required 40 percent; Mexico, 35 percent; and Chile and Peru, about 33 percent.

Countries cannot suspend their imports or reduce them below a minimum consistent with the effective operation of their economies. In view of this the above-mentioned debt-service ratios explain why the situation had become unsustainable by late 1982. On the one hand, the commercial banks saw that they could not go on lending large amounts for ever-shorter periods. On the other hand, the countries were unable to meet their import payments as they had suffered large losses in their international reserves and were falling behind in their external payments. When commercial bank credit was suspended, the lack of confidence in domestic currencies precipitated exchange crises, and the gravity of the situation became clear. Latin America's worst economic crisis of the century had begun.

Domestic causes

The domestic causes of the debt crisis may be traced to the growing fiscal deficits that most countries incurred between 1978 and 1982 and the expansionary monetary and credit policies that were largely used to finance them. While other factors also contributed to the inconsistency of economic policies, the primary factor was a level of public—as well as private—expenditures that exceeded currently available resources or resources that could have been regarded as stable in the medium term. Thus, between 1978 and 1982 the ratio of fiscal deficit to GDP more than doubled in the three main debtor countries, Argentina, Brazil, and Mexico.

How were those deficits financed? And what were the comparative effects of the different means of financing? Generally speaking, a fiscal deficit can be financed in one of two ways, external credit (borrowing

abroad or use of international reserves), and domestic credit. But—and this is of fundamental importance—there is a close and inseparable interdependence between internal and external credit: in the final analysis, the former determines the pattern of external financing.

Domestic credit for the public sector basically has two main sources: the central bank and the private sector. Opting for financing from the private financial system has important consequences—an upward pressure on interest rates as the government attempts to place its securities and, as a corollary of this, a decline in private investment as projects yielding less than the now higher interest rate cease to be profitable (the phenomenon known as "crowding out").

This problem of high interest rates is a delicate one, not only because of its effect on investment or, more accurately, on the distribution of investment between the public and private sectors, but also because high interest rates tend to become a difficult political problem as the monetary authorities are pressured to lower them. The basic problem is not the level of interest rates, as such, but the consistency of economic policies. Resources are finite, and one cannot at the same time increase private investment and use private savings to finance major public sector investments or higher current expenditure by the public sector.

The other source of domestic financing is central bank credit. In theory, this has the advantage that the interest rate paid by the public sector can be lower than what would have to be paid if bonds were to be placed with the private sector. But this presumed advantage is neither real nor permanent and implies even greater problems and risks than a short-run increase in interest rates. Although interest rates may initially tend not to rise because of the unanticipated excess liquidity, the public will soon realize that the situation is not sustainable. If the public is not willing to demand or hold the additional liquidity, it will proceed to "mop it up" by exchanging domestic financial assets for real assets—domestic or imported—or for external financial assets. The excess liquidity will inevitably lead to higher inflation, increased external borrowing or greater losses of international reserves, or a combination of both. These, in turn, will lead to a devaluation of the currency.

This is the previously mentioned monetary link between a fiscal deficit financed with domestic credit and its impact on the balance of payments. Within this context, a loss of international reserves is equivalent to an increase in the external debt, or it can be viewed as a temporary substitute for either higher inflation or a devaluation of the exchange rate. Statistical data for the countries under study tend to lend support to the linkages outlined above: the fiscal deficits of most countries had, as their counterparts, first an expansion of domestic credit followed by a series of mounting deficits in the current account of the balance of payments; these deficits, in turn, were the counterpart of the external debt or of losses of international reserves.

Admittedly, the numerous factors at work make it impossible to predict, in all cases and with mathematical precision, the precise relationship between the fiscal deficit and monetary and credit policy, on the one hand, and the balance of payments, on the other; but the direction and closeness of the relationship is unquestionable. For instance, the current account deficit of the balance of payments will vary according to the degree of the economy's openness to international trade, with smaller deficits where import restrictions are severe and larger deficits where the restrictions are milder. On the other hand, there will be higher inflation in the first case and lower inflation and greater economic efficiency in the second. In both cases the adjustment will bring aggregate expenditure to the level of the resources available—unless it is possible to postpone it. And this brings us to the second set of causes of Latin America's external debt problem, namely, financing by international commercial banks.

External factors

The external factors underlying the debt crisis may be classified into three groups. The first includes those that precipitated the 1982 crisis: the rapid rise in real interest rates in international financial markets, the world recession, and the difficulties in expanding export markets. These factors precipitated the crisis and certainly aggravated it, but, important though they were (and continue to be), they did not produce the crisis. Had external debt levels not been what they were, these developments could not in themselves have brought on a crisis, although they could have created serious problems. As it happened, they coincided with a situation that was already precarious.

The second group includes factors of a more permanent nature, in contrast to the transient ones mentioned above, and involves what economists call real, as against purely monetary, factors. The principal factor in this category was the decline in the terms of trade experienced by most Latin American countries, mainly as a result of the oil price increases of 1973 and 1979.

The third—and very special—group consists of external financing flows, particularly those from international commercial banks. Were it not for financing from these sources, which was growing rapidly and with ever-shorter maturities, an external debt crisis of the proportions experienced could not have developed. But this does not mean that this type of financing was the cause of the crisis. What this financing did was to facilitate the postponement of the measures that, in any event, would have had to be taken to adjust the economies in question to the deterioration in their terms of trade, as well as to the strictly monetary developments that occurred in 1979 and thereafter.

This last point is of particular significance in that it places the economic crisis in a proper perspective and underscores something that has sometimes been overlooked in the debate on recent economic developments, namely, the adjustment that should in any event have taken place beginning in 1974-75. In other words, the current crisis must not be regarded as an unexpected and surprising event that occurred in late 1982. To be sure, it should be set not against some normal or ideal situation but against the difficulties that would have been experienced some time after 1973 or 1979, had it not proved possible to obtain external financing from the international commercial banks in sufficient amounts to postpone corrective measures.

Nature of external financing

The specialization that characterized the external financing of Latin American countries, simply put, was as follows: The countries obtained development credits and long-term loans from multilateral entities and official agencies of the industrial countries (for the financing of capital goods exports). On the other hand, short-term credit, connected mainly with commercial transactions, was provided by suppliers or by international commercial banks. Generally speaking, the first category of loans—development financing—was linked to the feasibility of specific investment projects and was guaranteed by the borrowing country's government. The second category of credit was not government-guaranteed and pertained to commercial transactions between private sectors. This scheme of things began to undergo a rapid and fundamental change from 1975 onward. Although financing by multilateral entities and governments grew rapidly, credits from international commercial banks increased much faster. By the end of 1981, liabilities to international banks accounted for 63 percent of the total external debt of the 20 major borrowing countries. But it was not only the principal lender that had changed; the average maturity of loans had

shortened to the point where in early 1982 some 25 percent of these countries' debt was short term (that is, with an initial maturity of less than one year).

Other changes of no less importance were also occurring. An increasing proportion of the loans was no longer linked to the economic feasibility of investment projects. Most of them were being extended to public sectors for the purpose of financing fiscal deficits or investment programs in which the lender was no longer a direct participant in the project risk. This naturally led to a reduction in the application of strictness of project appraisal, while allowing the financing of a higher volume of government expenditure than could be sustained in the longer run. The fundamental role of the risk factor thus underwent a change.

The increase in international bank financing of the public sectors took place on the assumption that the loans involved little, if any, commercial or exchange risk, as a result of which commercial banks did not pay sufficient attention to the global risk represented by the quality of the debtor countries' economic policies as a whole. At the same time, the growing international bank financing of the countries' private sectors was also carried out on the assumption that the operation involved no risk for the public sectors of the debtor countries. This ignored the danger of a possible total and instantaneous suspension of external commercial financing.

It is now clear that all the protagonists were mistaken in their perception of the risk involved. Developments have confirmed at least three postulates: risk is a fundamental factor in market equilibrium; all private external credit involves a certain amount of risk for the public sector of the borrowing country; and private credit to the public sector involves certain risks for the lender. All in all, risk plays a stabilizing role in the maintenance of market equilibrium.

Effect on economic policy

In principle, although foreign credit represents a liability for the borrowing country, it also produces an asset. Unfortunately, this was often not the case in practice in Latin America. Loan proceeds were not always well invested or used to generate foreign exchange or supplement domestic savings. At times, indeed, borrowing financed consumption rather than investment. As a result, the ratio of external debt-service to exports of goods and services rose steeply. It is true that a large part of these increases represented rising interest rates in international markets, but interest rates were also rising for other borrowing countries (i.e., some East Asian countries) that followed different economic strategies and used the external financing to create and expand export industries.

One of the most surprising results of any analysis of Latin America's external debt data is the lack of a direct correlation between the aggregate debt and the deficit on current account and changes in reserves. Theoretically, a country or a region taken as a whole cannot accumulate external debt in excess of the total of its deficits on current account and the changes in its international reserves. It is assumed that external liabilities cannot be greater than the amount of the deficit less the losses in reserves. In the case of Latin America, however, external liabilities exceeded estimated external financing needs. The reason is well known: capital flight.

In its latest *Annual Report*, the Bank for International Settlements estimates that capital flight from Latin America between 1978 and 1983 amounted to possibly $50 billion. These funds, and those previously transferred abroad, are obviously not "lost" and the region's actual aggregate debt position is thus not as serious as it may appear. If the amounts relating to *net* external debt and *net* interest payments (received but not repatriated) were known, it could be seen that investment in activities that generate foreign exchange was higher than indicated by the figures for investment in the exporting sectors, but with an important difference: capital flight neither creates jobs nor pays taxes in the country of origin.

The thrust of the foregoing analysis is that the countries in question did not follow the correct policies to take advantage of the increase in external financing made available to them. The surprising fact is that in most of the cases the increased inflow of external funds was accompanied by a *drop* in domestic savings as a percentage of GDP. Thus, given the imbalance created between the growth of external debt and domestic capital accumulation, a debt crisis was virtually inevitable. In sum, the region lacked not funds but better policies for the use of these funds.

Lessons of the crisis

It is not easy to reach firm conclusions about the experience of the external debt crisis, and perhaps the perspective of a longer period is needed before we can draw the lessons of these events. Nevertheless, a number of broad conclusions are possible.

First, countries do not have an unlimited capacity to absorb external financing and to make proper use of all the funds they may be granted at a given moment. A situation in which a country's absorption, measured in terms of consumption and investment, exceeds its income, must not be confused with the very different situation in which the absorptive capacity for investment limits the total amount of resources that can be economically used. In other words, if there is additional financing, total absorption can exceed income, but the mere availability of financing does not guarantee the economic use of funds. If the availability of the external financing is not contingent on the economic feasibility of specific investment projects, and, consequently, if the risk factor is not sufficiently taken into account, it is highly probable that some irrecoverable loans will be granted. On the other hand, if there is easy availability of finance, it is also highly likely that this will reduce the discipline on countries to adopt better economic policies.

Second, the public sectors of the countries in question had neither the needed taxing capacity nor the domestic savings required to service the external financing offered to them. Fiscal deficits thus rarely contribute to higher total investment. Neither domestic nor external credit can be permanent substitutes for, or alternatives to, fiscal discipline. Sooner or later total expenditure will have to be brought into line with total resources, and financing cannot postpone that adjustment indefinitely.

Third, since external loans must be repaid in foreign exchange, external borrowing decisions must be linked to a general economic policy framework that will guarantee both the profitability of the investment and the generation of sufficient foreign exchange for external debt service. The maintenance of a realistic exchange rate policy is essential to attain this objective.

If these general conclusions lead to a single recommendation, it is that countries must view their external financing policies in the framework of their global macroeconomic policies, and that, within such a framework, adequate financial programming must assure a minimum of consistency between objectives, resources, and instruments. F&D

Robert Townsend for F&D

Eduardo Wiesner
a Colombian, graduate of Stanford University, has taught at Universidad de Los Andes (Bogota) and was Minister of Finance and Director of National Planning in Colombia. He is currently Director of the Fund's Western Hemisphere Department.

The case by case approach to debt problems

The Fund's recent role in debt management

Azizali F. Mohammed

The role of the Fund in assisting its member countries with their debt problems has changed since mid-1982, in response to a shift in the characteristics of the problems. In the preceding decade, countries with debt difficulties fell into one of two broad categories: (1) those more largely dependent upon officially financed or insured credits, and (2) others that borrowed mainly from private sources. For countries in both categories, debt problems were perceived as individual occurrences, without wider implications.

For the first category, a well-established set of procedures to redress the problems existed through the Paris Club framework for restructuring official debt. These were not formally codified rules, because creditor governments never did treat debt relief operations as anything but exceptional, undertaken at the express request of an individual debtor government, in the face of accumulating payments arrears and an evident inability to maintain debt-service payments. Before agreeing to modify the terms under a Paris Club renegotiation of debt, by stretching out maturities of principal and interest, creditor governments expected the debtor country to have negotiated a stabilization program supported by the Fund through a stand-by arrangement in the upper credit tranches (this has occurred without exception since 1977). Fund staff at Paris Club meetings were relied upon to furnish an objective assessment of recent economic performance, the main elements of a current adjustment program with the Fund, and the debtor's balance of payments prospects and external debt outlook.

The second category of cases consisted mainly of middle-income countries that ran into difficulties because of weak domestic policy or unanticipated exogenous developments, or a combination of both. Here solutions appeared to be achieved in two stages. First, private creditors, mostly commercial banks, were approached by the debtor government, especially when arrears on bank debt-service payments appeared earlier than on official obligations. However, the banks quickly came to realize that in negotiating with a sovereign borrower in this situation, it was not easy to work out conditions that would give them sufficient assurance that policy changes adequate to prevent a recurrence would be implemented. It was therefore natural that in most of the bank debt renegotiations that were conducted between 1975 and 1978, the banks, as a second step, urged the debtor countries to undertake stabilization programs supported by the Fund. As a result, for five of the six countries negotiating with the banks during that period, a stand-by or extended arrangement was in effect when the banks signed the final agreement.

The banks also found that in the highly competitive environment in which they operated, it was difficult to reach common ground on the financial terms and conditions of debt relief. Often with 200 or 300 banks from a number of countries involved, the need for fair treatment required "lead" banks to make massive and often time-consuming efforts to obtain cooperation from all the creditor banks; this was particularly important given the "cross default" clauses in most agreements, which would have created a chain reaction if some banks declared a debtor country in default. Moreover, the anxiety of banks to ensure that their claims would be treated no less favorably than those of others often led to an insistence that the debtor government approach its official creditors through the Paris Club, if it had not already done so. Thus, four of the six countries that renegotiated their bank debt over 1975–78 concluded official debt restructurings, and three of these came into effect before agreement was reached with the banks. When an official restructuring took place, the Fund's role reverted to that described for the first category of countries. However, the Fund staff also participated in some of the negotiations with the banks, including (with the knowledge of the debtor) meetings in which the debtor was not present. On occasion, the Fund assumed a more active role, at the request of the debtor authorities, in facilitating discussions with the banks. The Fund also provided technical assistance to some of the countries in preparing their discussions with the banks and helped with the compilation of statistics.

The Polish debt crisis of 1981 moved the problem into a new phase, in which "contagion effects" became a factor. The commercial banks suddenly developed an intensified perception of risk in lending to the East European countries as a group; this affected Romania and Yugoslavia, both Fund members, and Hungary, which became a member in 1982. The countries concerned were able to provide assurance to the banks, by entering into stand-by arrangements with the Fund, that appropriate policies were being adopted to reduce the risk of default. Once an arrangement with the Fund was in place, the banks were found willing to proceed with new credits as well as with refinancing maturing debt.

Until this stage, the Fund's attitude was generally to try to help the debtor country devise a program that gave assurance that it could resolve its balance of payments

difficulties in a medium-term framework. In some instances, the Fund staff did seek "indications of the likely magnitudes involved in a bank debt restructuring and also indicated to the banks the level of bank financing that it considered crucial to the success of a reasonable adjustment effort" (see IMF Occasional Paper No. 3, *External Indebtedness of Developing Countries*).

Change in conditions

As the debt problems of Mexico, and then those of Argentina and Brazil, became apparent, a perception developed that their reliance on commercial flows was so great that it entailed a distinct risk of program failure, unless the Fund could ensure that the financial assumptions on which the program was based were secured by explicit prior commitments from the banks to cover their share of the financing requirements of the program supported by the Fund.

It was the need to obtain agreement on the provision of additional bank and official finance *before* the approval of a Fund-supported arrangement that altered the role of the Fund in relation to commercial banks in the management of the debt problem. For, in addition to its certification function, the Fund developed a coordinating role as a mobilizer of funds from other lenders. This departure arose from several considerations. As noted earlier, the Mexican reliance upon bank financing was so large, and the assistance that could be furnished by the Fund so small relative to the need, that it was essential for the commercial banks not only to maintain their exposure but also to be prepared to enlarge it through the provision of additional financing. It was recognized that without such support, the compression of the economy, made unavoidable by lack of adequate external finance, might well make the situation unmanageable and render the Fund's own financial contribution ineffective.

Further, it was important to keep all elements of the banking industry involved. The major commercial banks understood that their stakes were so high that they could not afford to pull out without greatly reducing the quality of their own assets. The problem was to ensure that hundreds of other banks, especially the regional and smaller banks in the United States, would stay in the picture. If they did not, the major banks would be placed in the impossible position of having to explain (to shareholders, if not to depositors) why they were getting deeper into a country from which other banks were hastily extricating themselves. This was the issue of maintaining market discipline, i.e., preventing an uneven reduction in exposure by a large number of different lenders through, for example, withdrawal of short-term trade finance or the rundown of interbank deposits. There were also complex issues of intercreditor equity among banks with very different exposures, operating in different regulatory environments, and with varying accounting conventions, disclosure requirements, and funding constraints. These differences required formulas to be devised, in cooperation with the various national supervisory authorities, for allocating the net increase in exposure among the many banks from a number of national banking systems.

Finally, speed in decision making was imperative, requiring tight but credible deadlines. A series of highly complicated and closely articulated relationships had to be managed among a very large number of players—involving, in the case of Mexico, over 500 banks, their supervisory authorities in more than a dozen countries, governments of creditor countries, the Bank for International Settlements, the World Bank, and, of course, Mexico. The Fund found itself at the center of this web of relationships, as it was later when similar arrangements were established for Brazil, the Philippines, and Argentina, among others.

In each case, an agreement with the Fund became the basis for mobilizing much larger sums by way of restructuring and new financing, than those it provided directly. This was natural since the adjustment effort mounted by the debtor country was the prime factor in assuring its creditors that corrective action was being taken, that it had the support of the international community through the Fund, and that its progress would be carefully monitored. The task had to be tackled country by country, and not only because of the obvious fact that the Fund could operate best through a stand-by or extended arrangement with each of its debtor member states. The fundamental judgment on the balance between adjustment and financing had to be made in each case, based on the initial conditions prevailing at the time of the debtor country's approach to the Fund; the level of its foreign exchange reserves and its accumulation of payments arrears; the types of claims involved; the proportions of debt owed to different creditors; the number, size, and national affiliation of the banks involved; and so forth.

Special problems arose with the interbank market in the case of the two largest debtors. Branches or affiliates of debtor country banks located in the main financial centers, especially New York and London, had borrowed substantial sums at very short maturities and re-lent them at longer maturities to their principals or to other borrowers in the (debtor) home country. These interbank deposits presented the most difficult problem of preventing the withdrawal of funds, let alone assuring a net increase in exposure. These differences in country situations often emerged in the course of managing the crisis and had to be resolved quickly and in a manner that protected the cohesion of the various interests engaged in the rescue effort.

General solutions?

Various generalized solutions were proposed during this period, born of a conviction that the burden of debt servicing confronting a number of countries simply could not be managed in a world marked by deep recession, historically high interest rates, and a sharp curtailment of commercial lending. These schemes did not make much headway, however, for several reasons.

First, they proceeded from a perception about the global aggregates that was never true for the components. The existence or absolute magnitude of countries' borrowings was not in itself a reason for payments difficulties nor was the type of economy concerned. Recent data on debt and debt ratios for all developing countries, and equivalent figures for the different categories among developing countries, show that within each group were countries unaffected by a debt problem.

Among oil exporters that were OPEC members, two (Algeria and Indonesia) owed about 45 percent of the debt of their category, yet had no particular problem of market access. Of the net oil exporters among developing countries that were not OPEC members, Egypt and Malaysia accounted for about one fourth of the group's debt but, again, had no access difficulty. Among the net oil importers, about one half the debt was owed by the major exporters of manufactures, and four countries in this group (namely, Israel, Korea, Portugal, and South Africa), accounting for roughly one third of the total debt of the group, continued to borrow at very competitive terms throughout the period. In the low-income category, the two largest countries—China and India, which accounted for almost 40 percent of the debt—had no need for relief. Finally, in the residual group, at least three major borrowers had confronted their problems earlier and were already on the mend (Hungary, Romania, and Turkey), and two others (Colombia and Thailand) continued to have access on competitive terms. Any attempt to apply a general solution would have meant that countries whose creditworthiness was unimpaired would face interruptions of market access; a generalized ap-

proach could well create a new problem rather than provide a solution for an existing one.

A second factor militating against generalized solutions was that many of them implied large losses for commercial banks, inflicted in a manner that would prevent a gradual process of building up reserves and allowing write-offs over a period of time. Schemes to transfer bank claims on developing countries to international or national public entities would have involved either substantial public sector commitments or immediate and open losses for the banks. This would have risked breaking the nexus between commercial banks and their customers in the developing countries and destroying relationships built up over many years, if not decades. The debtor countries not only relied upon the international banks for normal trade financing but also expected to reactivate their access to markets for project and sectoral finance. Indeed, the promise of being able to attract new flows as existing credits were repaid was at the heart of the unflagging commitment that most debtors displayed in their approach to the debt problem. Generalized solutions tended to categorize problems mechanically according to quantitative criteria, such as levels of net capital flows or net resource transfers, whereas solutions to individual cases needed to be more sensitive to the organic interrelationships that underlay the financial magnitudes.

A third flaw of most generalized solutions lay in their assumption that support would be forthcoming from the governments of the major creditor countries. The political environment was not conducive to such use of public funds. In many countries, there was a drive to cut back on budget deficits, and any solutions that impeded the attainment of this objective were unlikely to find favor with financial officials and legislators. An even greater problem lay in a widespread public perception that the commercial banks had lent in an imprudent way, and that public funds should not be employed to rescue large private institutions from the consequences of their own errors of judgment. Similarly, while developing countries experienced serious adverse external conditions, their payments difficulties resulted in part from inadequate domestic economic policies. There was also a feeling that many of the countries that were in difficulty were among the most developed among the developing countries and that assisting them with public funds would skew the distribution of aid flows away from countries that were poorer, had little or no recourse to market borrowing from abroad, and stood perhaps in even greater need of external assistance for dealing with their problems.

A final difficulty with some generalized solutions concerned the time that their implementation would require. Many schemes would have required changes in national legislation or in the charters of international institutions whose amendment necessitated high voting majorities and large participation ratios to become effective. Yet in dealing with debt problems as they arose, time was of the essence and the constraints set by the need for urgent action meant that solutions had to be found within the bounds of existing legal and institutional arrangements.

The individual solution

With the passage of time, some evidence of the viability of the cooperative approach to debt management has begun to accumulate. In the 18 months ending in mid-1984, the external adjustment that has taken place in the non-oil developing countries has been characterized as "dramatic," and while it is recognized that sharp cuts in imports were involved, growth has resumed in a number of them.

On the financing side, the Fund (as of the end of 1984) had disbursed some $22 billion since the middle of 1982 to support adjustment in nearly 70 member countries, with another $8 billion of commitments outstanding under 31 current programs. In addition, new financing has been mobilized along with debt rescheduling. In 1983, some 30 developing countries (including 11 of the 25 largest borrowers) completed or were in the process of completing debt rescheduling agreements with official and commercial creditors. These agreements reduced the debt-service payments of non-oil developing countries by $23–24 billion in 1983, and by about the same amount in 1984. As a result, their debt-service ratios declined from a peak of 25 percent in 1982 to 22.3 percent in 1983. This compares with 27.6 percent, which would have applied in the absence of rescheduling. The maturity structure of debt has also been improving, with the ratio of short-term debt declining to 25 percent in 1983 from about 30 percent of exports of goods and services in 1982 and to an even lower ratio in 1984. In 1983, $13 billion of bank lending was also arranged in conjunction with Fund-supported adjustment programs.

Azizali F. Mohammed
a Pakistani, holds degrees in economics from the Universities of Bombay and Sind, and a PhD from The George Washington University. He joined the Fund staff in 1960 and is now Director of its External Relations Department.

Despite these encouraging developments in the debt situation and the recovery in the industrial world, considerable pessimism has persisted over the manageability of the debt problem. One explanation for this paradox is that lags exist between actions taken by debtor countries and the recognition of their positive results. A second reason is the concern over the prospect of a "hump" in countries' debt amortization in the next few years, resulting from the reschedulings of 1982–83. A third factor is the rise of about 2 percentage points in interest rates in the first half of 1984. This disturbing development has generated another spate of generalized solutions for "capping" interest rates and for reducing the burden of higher interest rates in other ways. There is no question that higher rates pose a risk to the viability of the solutions that have been found. However, before giving credence to the solutions proposed, two sets of factors must be kept in view, the first general and the second more specific.

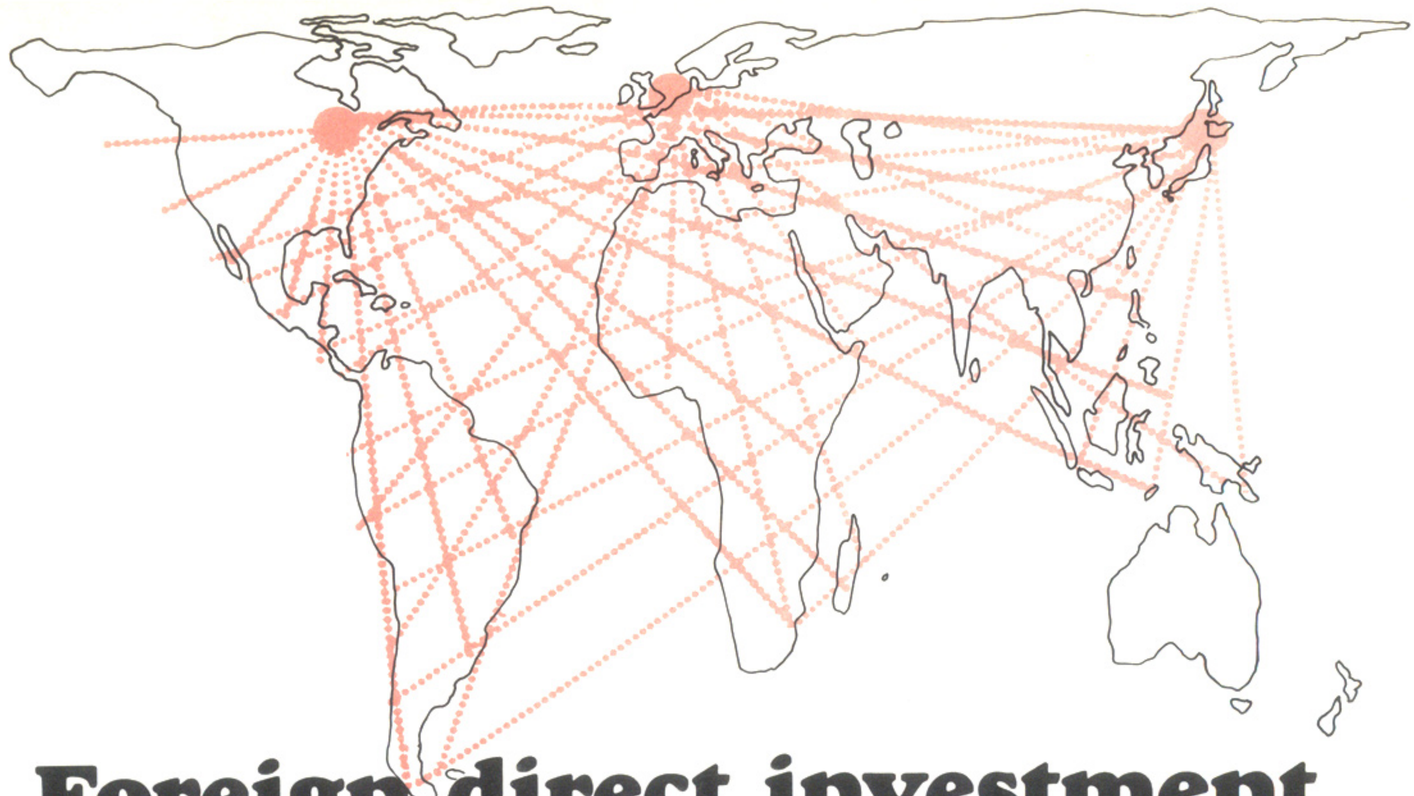
At the more general level, there are several elements to be considered. First, the trough in imports of non-oil developing countries was reached in the fourth quarter of 1982, with imports from industrial countries falling by about 20 percent in U.S. dollar terms from early 1981 to late 1982. Thereafter, the financing packages put together in association with Fund programs were sufficient to stabilize the level of imports. Second, the exports of non-oil developing countries to the industrial countries began to recover from the fourth quarter of 1982 with the recovery in output in the industrial countries. As a result, the exports of these countries rose from some $190 billion (at an annual rate) in that quarter to some $240 billion in the first quarter of 1984. This expansion of exports helped bring about an improvement of around $70 billion (at an annual rate) in the trade balances of this group of countries. This is expected to result in a resumption in the growth of imports, projected to rise in volume terms by about 6 percent in both 1984 and 1985, despite any increase in the burden of interest charges on non-oil developing countries (net of interest earned).

At a more specific level, the effects of interest rate movements on dollar-denominated debt are sufficiently country-specific to require careful and individual

analysis. There is, first of all, a wide variation in the reliance of countries on floating rate credit. Most of the poorer countries in Africa and Asia have not been significant users of such credit, some because they chose not to. Second, the proportion of variable rate debt in total debt has varied. Third, the interest rate factor has been offset to a varying extent by improvements in export receipts, following the strong upswing in North America that has accompanied the hardening of interest rates. The offsetting benefits have been greatest for countries such as Mexico, because of their proximity to the U.S. market, but the upswing has also helped countries farther away which have a highly diversified productive base, such as Korea, and possess the flexibility to adapt rapidly to the requirements of a booming North American market. There is a recognition that imaginative solutions may still become necessary were interest rates to rise or commodity prices to weaken further. However, there is an inclination to confine the search for such solutions to the banks negotiating with each debtor country, with support from the supervisory authorities of the banks and also from the Fund and the World Bank.

An application of this approach was the acceptance by the banks of the proposal advanced by the Fund's Managing Director in 1984 to consider a longer time frame for bank rescheduling arrangements for countries that have made or are making substantial progress toward adjustment, as a way of recognizing good performance, avoiding the necessity for repeated annual reschedulings, and restoring the conditions needed for the return to market access, as well as for rebuilding confidence in the system. The Managing Director proposed such an approach for Mexico and expressed the hope that other countries whose performance is improving could also qualify, if their progress is sustained. The periods of consolidation, as well as of grace, would have to be longer for these advantages to be obtained and the terms and conditions would have to improve. The successful completion of multiyear restructuring agreements with Mexico and Venezuela illustrate the banks' readiness to adopt a forward-looking approach to debt restructuring, and represent an important step in preparing the way for countries' return to more normal market access. In the case of both countries there is a provision for the Fund to continue a monitoring role through its regular surveillance procedures, but on an enhanced basis.

The need for a longer-term perspective on debt management is important, and not only on the financial side. In spite of the progress already made, the debt problems are not going to vanish overnight. Their effective resolution will depend, first and foremost, upon continued action on the part of the indebted countries themselves aimed at strengthening their economies over a period of years. These efforts both need and deserve the support of the international community. The industrial countries need to make further progress toward a better and more stable world economic environment and the conditions in which international trade can flourish. Continued cooperation among financiers will also be required to ensure that determined adjustment efforts receive the necessary financial backing. The Fund, for its part, will have a role to play in all these areas in the years ahead. F&D



Foreign direct investment in developing countries

Trends, policy issues, and prospects

David Goldsbrough

The relative importance of direct investment in the capital flows to developing countries has been declining since the early 1970s. While direct investment continued to increase in absolute terms, bank credit has become a much more dominant factor in private capital flows. Some observers have argued that this shift in the composition of private capital flows has increased the vulnerability of the developing countries to external payments difficulties. Moreover, with relatively slow growth in bank lending to these countries in prospect for the medium term, other sources of external financing, including direct investment, will be required if the pace of development is to improve. With these considerations in mind, this article examines some of the causes and consequences of the decline in the relative importance of direct investment since the early 1970s and discusses the conditions and modifications in policies in both lending and borrowing countries that might encourage larger flows of such investment. Direct investment also involves the transfer of a package of resources, including technological and managerial expertise in addition to capital; these may have an even greater impact than capital flows on a recipient country's production capabilities. However, this article is concerned with the macroeconomic aspects of direct investment, in particular with its role in capital transfers and adjustment.

Direct investment refers to investment made to acquire a lasting interest and an effective voice in the management of an enterprise. Many countries set a minimum proportion (generally between 10 and 25 percent) of foreign ownership of the voting stock as evidence of direct investment. In principle, all capital flows provided by direct investors, including equity capital, reinvested earnings, and net lending, are classified as direct investment.

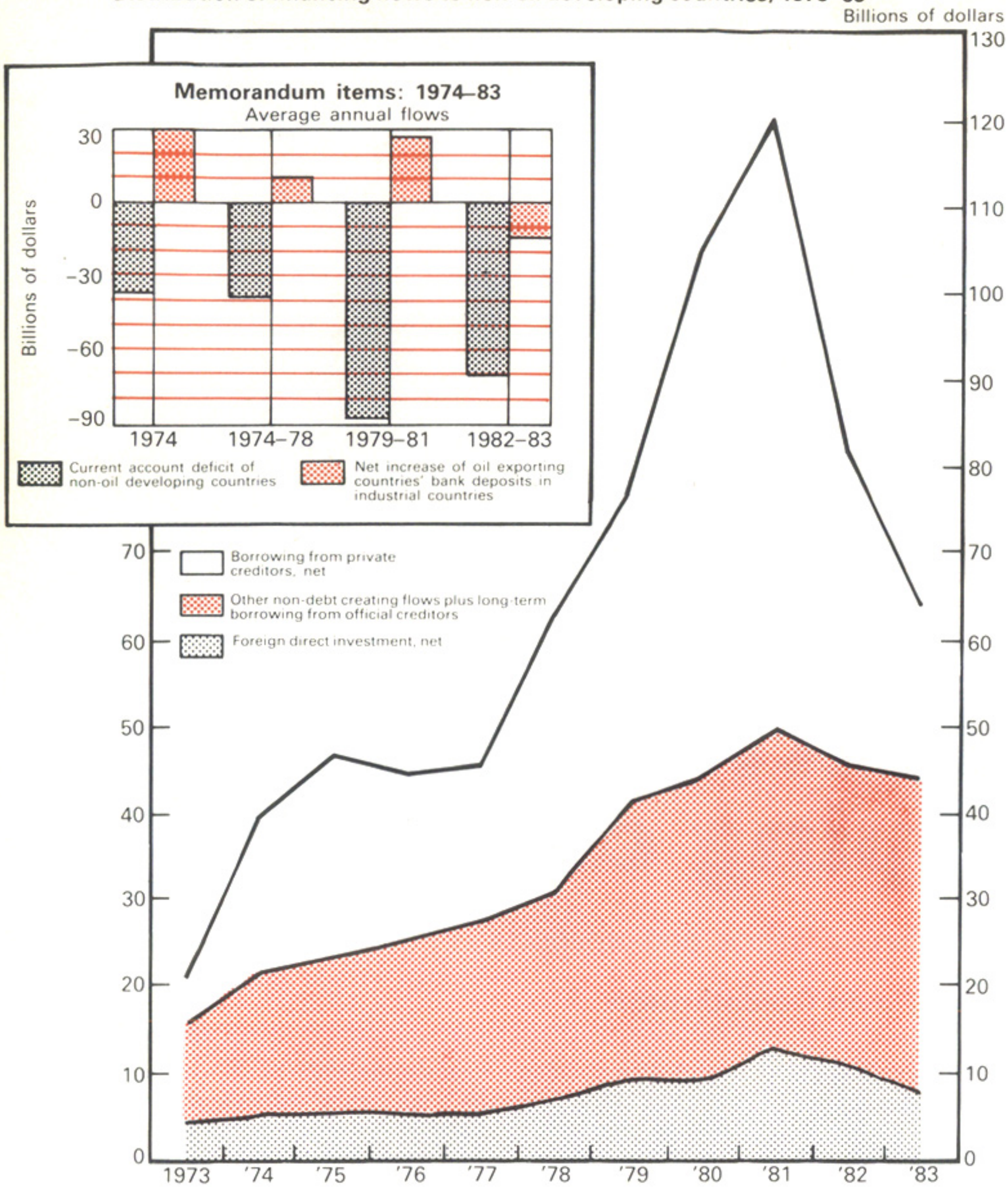
Trends in investment

Net inflows of foreign direct investment into developing countries generally increased throughout the 1960s and 1970s. Direct investment flows from industrial to developing countries rose from an average of under $2 billion a year during the early 1960s to an average of around $13 billion a year during 1979–81. However, their share in total capital inflows declined substantially as external borrowing, particularly from commercial banks, grew rapidly.

Although the rapid expansion of commercial bank lending was already underway before the first large oil price increase of 1973–74, that event accelerated the decline in relative importance of direct investment flows, especially for the non-oil developing countries, which financed most of their larger current account deficits by external borrowing. In 1973, direct investment flows financed some 20 percent of the combined current account deficit and net accumulation of reserves of non-oil developing countries, compared with an average of only about 12 percent in later years (see chart). Nevertheless, these inflows continued to increase in real terms—at an average annual rate of about 3 percent in terms of constant prices—to an average of about $10.5 billion during 1979–81, but declined during the recession of 1982 and 1983.

As a consequence of the shift in the composition of financing, the structure of the external liabilities of these countries

Distribution of financing flows to non-oil developing countries, 1973–83[1]



Sources: IMF, *World Economic Outlook*, 1984 (Occasional Paper No. 32), *International Capital Markets* (Occasional Paper No. 1), and *External Indebtedness of Developing Countries* (Occasional Paper No. 3).
[1]Excluding reserve-related liabilities and errors and omissions.

changed significantly. The share of direct investment in total gross external liabilities (total external debt plus stock of foreign direct investment) of non-oil developing countries declined from an estimated 26.5 percent in 1973 to 17 percent in 1983, while the share of public and publicly guaranteed debt to private financial institutions rose from 10 percent to 25 percent (see table).

These global trends mask a wide diversity of experience in individual countries, resulting from differences in both economic environment and policies toward foreign direct investment. Much of this investment is concentrated in a small number of countries that have large domestic markets, are rich in natural resources, or have significant advantages as a base for export-oriented production. Five countries (Brazil, South Africa, Mexico, Singapore, and Malaysia) accounted for almost one half of the stock of direct investment in non-oil developing countries at the end of 1983. Nevertheless, some other countries that also have large domestic markets (such as India and Turkey) or that successfully pursued an export-oriented development strategy (such as Korea) were much less reliant on direct investment.

The United States has been the principal source of private direct investment in developing countries, although it declined in relative importance in recent years along with the two other traditional sources—the United Kingdom and France—while direct investment from Germany and Japan grew rapidly. The stock of U.S. direct investment in developing countries grew at an average annual rate of less than 10 percent during 1970–82, compared with growth rates of 17 percent and 21 percent for Germany and Japan, respectively. However, in 1982 the United States still accounted for almost half of the total stock of such investment. Together, the five largest source countries have accounted for some 85 percent of direct investment flows from industrial to developing countries during recent years.

The returns on direct investment flows have fluctuated with changes in the global economy. Total net recorded dividends and net interest payments by developing countries on direct investment rose from $9.5 billion in 1973 to a peak of $26.5 billion in 1981, but then declined to less than $18 billion in 1983, when profits fell sharply as a result of the world recession. Most of the increase between 1973 and 1981 came from the major oil exporting countries; the later decline reflected lower oil prices and a weakening of the economies of some of the oil exporting countries. Payments from non-oil developing countries rose from $3.5 billion in 1973 to $9.5 billion in 1981, before declining sharply to an estimated $6.25 billion in 1983. Expressed as a percentage of exports of goods and services, non-oil developing countries' total payments on direct investment declined gradually over the decade from 3 percent in 1973 to less than 1.5 percent in 1983. Meanwhile, interest payments on external debt rose from some 6 percent of exports of goods and services in 1973 to over 13 percent in 1983, reflecting the increased emphasis on financing of the balance of payments through debt.

Changes in financial markets

Structural changes in the financial system were already underway by the late 1960s as major banks increased their international operations and, attracted by promising growth prospects, greatly increased their lending to some of the more rapidly industrializing developing countries. This trend was continued after 1973, as the relatively risk-averse asset preferences of oil exporting countries led them to hold many of their assets in the form of liquid bank deposits. Together with the greatly increased demand for medium- and longer-term financing by developing countries, this provided banks with the opportunity to expand their role as international financial intermediaries. To indicate the magnitudes involved, the cumulative current account deficits of non-oil developing countries over 1974–83 amounted to $588 billion, while net borrowing from banks by these countries was $216 billion and the net inflow of direct investment $82 billion (also see chart). Much of the new bank lending was either to, or guaranteed by, governments and was encouraged by the view

that the risks associated with such lending were relatively low in comparison to normal commercial lending.

In contrast, there was much less scope for large immediate increases in direct investment, which depended on the identification of individual opportunities for profitable investment and was influenced by a wide range of institutional restraints that could not be altered quickly. A considerable part of the external borrowing was undertaken by governments to finance balance of payments or fiscal deficits and it might have been difficult for foreign equity capital, which is more directly associated with private enterprise investment, to substitute for a substantial proportion of such borrowing, at least in the short term. This is because most developing countries have limited and fragmented capital markets, which means that the particular causes of a macroeconomic imbalance have a strong influence on the composition of capital inflows. Even so, longer-term possibilities for substitution between direct investment and borrowing from commercial banks as sources of capital inflows can still be significant, especially for countries with substantial domestic markets or natural resource endowments; these countries were often among the larger borrowers from commercial banks. In this regard, restrictive policies adopted by many developing countries toward foreign direct investment also seem to have contributed to a greater reliance on bank credit.

Host country policies

Most developing countries combine some degree of regulation and control of direct investment, aimed at improving net benefits to the host country, with various incentives designed to attract such investment. In general, during the 1960s and much of the 1970s there was a trend toward greater restrictions. Increased availability of alternative external financing, disappointment with some of the results of direct investment, and growing nationalist sentiment in many countries all contributed to this trend.

Although the combination of policies chosen depends to a large extent on a country's development strategy and market philosophy, the underlying attractiveness of a country as an investment location is also important since this affects its relative bargaining strength vis-à-vis potential direct investors. A number of countries (particularly in Africa and the Caribbean) were unable to attract significant inflows of direct investment despite offering substantial incentives, because of their small domestic markets and limited natural resources. However, a few territories and countries with relatively small domestic markets (including Hong Kong, Singapore, and, to some extent, Malaysia) that pursued open economic policies and maintained few restrictions on foreign investment were able to attract substantial export-oriented direct investment, while generally offering only moderate incentives. Many other countries imposed a number of restrictions or specific performance requirements on such investment, as they sought to extract greater benefits.

Restrictions and regulations often acted as a barrier to the entry of new investment, but they were sometimes offset by a country's attractive location, especially if they were not too complex or subject to sudden and frequent changes. The provision of a stable economic environment and the adoption of appropriate financial and exchange rate policies are probably at least as important for encouraging foreign investment and for increasing the flow of new benefits to the host country as are policies related specifically to such investment.

Recent trends in a number of countries indicate a liberalization of policies in order to attract more foreign investment. Some countries (including Egypt, Jamaica, the Philippines, and Turkey) shifted from policies that emphasized detailed control of direct investment to much more flexible arrangements, while more gradual policy changes took place in other countries (including Korea, Mexico, Morocco, and Pakistan). The policies of some centrally planned economies toward foreign direct investment were also modified in recent years. One of the greatest changes took place in China, which now encourages investment through either joint ventures or wholly foreign-owned enterprises, and has liberalized regulations governing the purchase of inputs and the sale of a proportion of output on the domestic market (see the article by Luc De Wulf in this issue).

Industrial country policies

At present, most industrial countries maintain relatively few restrictions on capital outflows and provide some encouragement for direct investment in developing countries, through guarantee and insurance schemes and various forms of official financial support. The decline in the relative importance of direct investment in total capital flows to developing countries during the 1970s was not due to any major change in such policies. Nevertheless, the protectionist trade measures adopted in recent years could have discouraged direct investment since they reduced opportunities for profitable investment in export sectors where developing countries have demonstrated a comparative advantage.

Most industrial countries provide insurance for new direct investment in developing countries, generally with coverage of noncommercial risks such as expropriation, losses due to war, and inconvertibility of dividend and capital transfers. However, with the exception of Japanese and Austrian direct investment, more than half of which is covered by such insurance, existing official arrangements cover only a small fraction—generally less than 10 percent—of industrial countries' total direct investment in developing countries. The World Bank is exploring a multilateral investment insurance scheme that would build upon and complement existing national

Foreign direct investment and external debt in developing countries, 1973–83

	Stock of foreign direct investment[1] (In billions of dollars) 1973	1983 (Estimate)	Total outstanding external debt[2] 1983	Share of foreign direct investment in total gross external liabilities[3] (In percent) 1983
Seven major borrowers	**20.0**	**59.6**	**350.1**	**14.5**
Argentina	2.5	5.8	44.4	11.6
Brazil	7.5	24.6	88.0	21.8
Indonesia	1.7	6.8	30.4	18.3
Korea	0.7	1.8	38.9	4.4
Mexico	3.1	13.6	89.4	13.2
Philippines	0.9	2.7	23.9	10.9
Venezuela	3.6	4.3	35.1	10.9
Non-oil developing countries	**47.0**	**140.9**	**685.5**	**17.0**

Source: Fund staff estimates.
[1] The 1983 end of year stock figures equal the estimated book value of the stock of direct investment from industrial countries at the end of 1978 plus total direct investment flows during 1979–83.
[2] End of year. Includes short-term debt, but not reserve-related liabilities.
[3] Total gross external liabilities are defined as stock of foreign direct investment plus total outstanding external debt.

and private schemes (see "Increasing private capital flows to LDCs" by Ibrahim Shihata in the December 1984 issue).

Effects on external adjustment

The shift in the composition of capital inflows into developing countries, toward more bank credit and less direct investment, is likely to have increased these countries' vulnerability to various economic disturbances. This is because, unlike debt, an equity investment requires no service payments unless it earns a positive return. In this sense, the greater the share of direct investment in a country's portfolio of external liabilities, the greater is the share of risk associated with economic disturbances that is borne by foreign investors. In addition, since direct investment can be sensitive to changes in a host country's relative competitiveness, as well as to its interest rate and credit policies, a higher proportion of such investment in total capital flows can increase the responsiveness of such flows to a country's adjustment policies.

Because of the greater risk associated with equity investment generally, returns on such investments usually need to be higher than those on external debt. The combination of risk and return that a country is willing to accept is determined not only by individual preferences within the country but also by the costs associated with maintaining service payments on foreign liabilities when economic conditions deteriorate. These costs generally result from the need to restore a sustainable current account position either by reducing aggregate expenditures or by switching resources from nontraded to traded sectors.

There is some evidence that total returns on equity investment are more correlated with a country's ability to service its external liabilities than are interest payments on external debt. For a group of non-oil developing countries for which sufficiently long time series are available on reinvested earnings, the estimated annual rate of return on direct investment was positively associated with the annual rate of growth of GDP; there was a similar, although much weaker, association with the rate of growth of exports. By contrast, there was little association between these countries' rates of growth of GDP or exports and the average interest rate paid on their outstanding external debt. The contrast in movements in rates of return and interest rates was particularly marked during the recent recession.

In light of the relationships described above, the process of adjustment to economic disturbances should be easier in a country with a large proportion of direct investment in total external liabilities. For 28 developing countries that rescheduled part of their external debt during 1983, the stock of direct investment accounted for an average of only 14 percent of their total external liabilities (i.e., direct investment plus external debt) at end-1983, compared with an average of 24 percent for those 49 developing countries with available data that did not reschedule debt.

However, the way in which variations in profits affect current account adjustment also depends on their distribution between remitted dividends and reinvested earnings, since this influences the immediate foreign exchange outflow. The share of earnings that are reinvested fluctuates substantially with changes in economic conditions. For example, there are indications that—at least during the recent recession—remitted dividends declined much less than did reinvested earnings, particularly for direct investment in the manufacturing sectors of developing countries.

Prospects and policies

The financing pattern that supported the upsurge in current account deficits of developing countries through 1981 is unlikely to be repeated. In particular, new net lending through the international banking system is likely to be much more constrained in the future, so that foreign direct investment will probably be needed to contribute a greater share of future capital inflows. New net bank lending to countries with heavy principal payments on rescheduled debt is likely to be particularly constrained. These countries could find it advantageous to encourage a greater inflow of direct investment so as to maintain resource inflows sufficient to support an adequate growth rate, as well as to reduce vulnerability to any future deterioration in economic conditions. There are, of course, many other factors which will affect these countries' overall growth prospects; for example, higher domestic savings rates could help achieve higher growth rates without increased reliance on foreign financing.

The scope and need for an increased role for such investment can be illustrated in the context of the medium-term scenario for developing countries prepared for the Fund's 1984 *World Economic Outlook*. Over the period of the scenario, 1986–90, foreign direct investment flows to non-oil developing countries are assumed to increase by around 5 percent per annum in real terms. However, the volume of direct investment inflows would only reach the peak level achieved in 1981 by around 1988 because much of the growth would simply represent a recovery from the downturn in direct investment that occurred in 1982 and 1983.

Such growth in direct investment flows appears achievable for the group of non-oil developing countries as a whole—though not necessarily for each country—provided that the generally more encouraging policies of recent years toward direct investment are maintained and that the improvements in the world economic environment assumed in the medium-term scenario are achieved. If the exposure of international commercial banks evolves as assumed in the "base" scenario (i.e., with total exposure unchanged in real terms, except for trade-related credits, which increase in line with imports), the share of direct investment in total financing of the combined current account deficit and reserve accumulation of non-oil developing countries would rise moderately, to around 15 percent in 1988–90 compared with some 11 percent during 1979–81. A more substantial liberalization of policies toward foreign private investment could lead to much greater inflows.

Many of the more heavily indebted countries will need to make more substantial changes in policies toward direct investment if they are to achieve the level of inflows consistent with the growth prospects of the "base" scenario. This will be especially so if, as seems likely, new bank lending to countries with a large volume of rescheduled debt expands less rapidly than lending to countries with a lesser debt burden. F&D

David Goldsbrough
from the United Kingdom, is an economist in the Developing Country Studies Division of the Fund's Research Department. He has a BA from Cambridge and a PhD from Harvard and has published articles on direct investment and multinationals.

A longer paper on this topic by the author is available as IMF Occasional Paper No. 33, entitled Foreign Private Investment in Developing Countries *(forthcoming). Copies are $7.50 ($4.50 to university libraries, faculty, and students) and can be ordered from the Publications Unit, International Monterary Fund, Box A-851, Washington, DC 20431, USA.*

Financing education in sub-Saharan Africa

Issues of equity and efficiency of investment—some policy alternatives

Alain Mingat and George Psacharopoulos

A country's educational system is the backbone on which many specific developmental objectives rest. The achievement of literacy, a sustainable rate of economic growth, and equitable distribution of income can be hastened through investment in education. Hence financial constraints on investment in education can have adverse long-term effects. This paper discusses these issues in sub-Saharan Africa, where financial constraints are especially pronounced, and contrasts the lessons to be drawn from two regions—francophone and anglophone Africa—that have followed different policies in financing education.

By any standard, economic growth in Africa has been slow; when it is combined with rapid population growth, the growth of per capita income in some countries has even been negative. The school-age population of Africa is the fastest growing in the world and expenditure on education is high compared with that in other developing countries, both in terms of the share of GNP allocated to education and the share of education expenditure in the state budget. The latter share is particularly high in the francophone countries.

Yet relatively high expenditures have apparently had less impact in Africa than lower expenditures elsewhere (Table 1). School enrollment ratios—those enrolled in relation to total school-age population—are substantially lower than in other parts of the developing world, while average adult literacy rates are also lower. It is also significant that while the burden of education expenditures on the state is higher in francophone than in anglophone Africa, average enrollment ratios in primary and secondary schools and adult literacy rates are appreciably higher in the anglophone countries. The effects of the higher government spending on education in francophone Africa are only evident in enrollment in postsecondary education, which is twice as high as in the anglophone group. Even allowing for differences in the social, political, and economic characteristics of the two groups of countries, the broader impact of expenditures on enrollments and adult literacy in English-speaking Africa demonstrates what could be achieved elsewhere.

Given the recognized impact of widespread basic education and literacy on development, it is important to isolate those factors that could hinder the provision of education to more people, particularly where population growth rates are high. The primary factors in Africa seem to be, first, very high costs per pupil (which are mainly borne by the state) and, second, a bias, particularly in francophone Africa, toward encouraging postsecondary rather than primary education.

Costs and misallocation

In all country groups, developed and developing, unit costs rise with the level of education (Table 2). But at all education levels, unit costs are proportionately highest in Africa, particularly those of primary and secondary education in francophone

Africa. The unit costs of primary education in terms of per capita national product are almost 2.5 times higher in Africa than in other developing countries; the costs of secondary education 4.5 times higher; and those of postsecondary education 8 times higher. These high costs are not attributable to either low student-teacher ratios (which, in fact, are on the high side in Africa, and particularly so in francophone Africa) or to the high quality of education, which entails expensive inputs. One cause of these high costs is teachers' salaries, which are high in relation to available resources; primary school teachers' wages are, on average, between two and three times higher in per capita terms in Africa then in Asia or Latin America, and wages in francophone Africa are almost twice the level of those in their anglophone counterparts (Table 3). Although part of this difference could be explained by the relative human capital shortage in Africa, a great part is due to ex-colonial links and the imitation of pay scales in the metropolis.

A second reason is the very large-scale state involvement in the financing of education; this accounts not only for capital and operating expenses but also for student subsidies whose importance rises with the level of education. State subsidization of education is particularly pronounced in francophone Africa.

Such large public involvement in the financing of education would be justified if it led to a socially efficient and equitable outcome. One way to assess its social impact is to compare the rates of return to different levels of education. The social rate of return for a given education level is calculated by comparing incremental gains accruing to society from individuals who attain that education level (in relation to those obtained from attaining the level below it) with the aggregate costs (direct and opportunity costs) borne by all participants (state and individuals) in financing education. The private rate is calculated by a similar method except that it takes account only of the costs borne by individuals. It follows that the greater the state contribution to the financing of education, the greater the margin by which the private rate of return exceeds the social rate. Estimates of the social rates of return of the various education levels can help the authorities decide on socially optimal resource allocation, while estimated private rates of return measure the incentives to individuals to obtain a given level of education.

Table 1
Education expenditure and educational development[1]
(In percent)

	Share of education in state budget	Enrollment: Primary	Enrollment: Secondary	Enrollment: Higher	Adult literacy
Sub-Saharan Africa					
Francophone[2]	22.6	46	14	2.4	18
Anglophone[3]	17.0	77	17	1.2	40
Asia					
Southeast Asia & Pacific	15.0	87	43	9.1	71
South Asia	8.8	71	19	4.4	25
Latin America	16.9	90	44	12.0	83
Developing countries	16.1	75	23	6.9	53
Developed countries	9.0	100	80	22.1	99

Source: World Bank data.
[1] Based on the latest data available, from the early 1980s.
[2] Francophone countries include Benin, Burkina Faso, Burundi, the Central African Republic, Cameroon, Chad, the Congo, Gabon, Guinea, the Ivory Coast, Madagascar, Mali, Mauritania, Niger, Rwanda, Senegal, Togo, and Zaire.
[3] Anglophone countries include Botswana, Ethiopia, The Gambia, Ghana, Kenya, Lesotho, Liberia, Malawi, Nigeria, Sudan, Swaziland, Tanzania, Uganda, and Zimbabwe.

Data on returns to education in Africa show investments in primary education to be the most socially efficient. Table 4 shows the private and social rates for three education levels based on a sample of 44 countries, grouped by region or development level. The social rates of return are highest in primary education for all groups, while higher education shows the lowest social rates of return. The discrepancy between social and private rates increases with rising education level—the increasing difference being especially marked in the African countries. Since it is the size of the private returns that provides the incentive to individuals to invest in education, it follows that African students are given strong incentives to invest in postsecondary education. This incentive pattern is not conducive to a socially efficient utilization of national resources.

The strong incentives for individuals to invest in postsecondary education also raise questions of equity. It may be more equitable to provide fewer incentives to individuals to invest in postsecondary education. First, it is primary education, which can be regarded as both a fundamental right of the individual and a sound economic investment, that needs to be further expanded—given its high social returns, existing low enrollments, and more particularly its relatively low unit costs. Second, state subsidization of students tends to be greater the higher the education level. But subsidies are not always necessary, since students in higher education are more likely to come from better socioeconomic backgrounds (and could afford to bear a greater share of the cost of their education) and, again on average, will realize higher incomes from their studies. They could therefore reimburse the state for at least part of the financial support they received while studying.

Estimates of the share of student subsidies (living expenses and stipends) in secondary and higher education confirm the sharp contrast between the expenditure pattern of the francophone and anglophone countries of Africa. In both groups, public subsidization for student living expenses is notably higher than in Asian developing countries, where they represent only 4 percent of the total public cost at the secondary and higher levels. In anglophone Africa, student subsidies represent 14 percent at secondary and higher education levels, while in francophone Africa the figures are much higher, 23 and 43 percent respectively. In countries like the Congo, the Central African Republic, and the Ivory Coast, scholarships and social expenditures even exceed teaching expenditures at the higher level. Student scholarships represent on average 120 percent of per capita GNP in the Ivory Coast, 160 percent in Senegal, 700 percent in Mali and the Central African Republic, and 800 percent in Niger and Burkina Faso (formerly Upper Volta).

There certainly exist valid arguments for subsidizing education systems and for not subsidizing them, based on grounds of efficiency, equity, ideology, politics, educational quality, or the flexibility of educational institutions. But when the affordable limit of state financing is reached, as it has been in the Ivory Coast, for instance, there is no option but to increase the private share of the burden of financing education or let its quality drop.

Policy implications

The high costs of education and low enrollments in sub-Saharan Africa, often combined with a socially inefficient emphasis on higher education, imply a need to review the allocation of resources among education levels to give higher priority to

primary education, especially in the francophone countries. This priority is justified on both economic efficiency and social equity grounds.

Student subsidies could be gradually abolished (or charges even introduced) to recoup part of the operating expenditures on secondary and higher education. (A limited number of scholarships or loans could be selectively provided to students in particularly adverse financial circumstances.) Reducing subsidies to individual students would improve efficiency by giving them more incentive to choose responsibly among alternative education options. Some reduction in enrollments could result, although it is known that aggregate demand is not very sensitive to increases in the cost of studies, especially when the private rate of return is already high. On the other hand, the "internal" efficiency of the education system would improve—rates of dropout and repetition would fall as students with low aptitude or motivation attracted by student aid leave the system. "External" efficiency would also improve as students would invest in specific training in response to labor market signals, helping to improve the linkage between education and the labor market. Finally, overall efficiency would improve as the resources saved could be used for primary education, where unit costs are much lower and social returns much higher. Such reallocation would raise both the real level of the country's education investment and the overall rate of return on education expenditures.

Table 2
Unit costs of public education at various levels
(As percent of per capita GNP)

	Primary	Secondary	Higher
Africa			
Francophone	29	143	804
Anglophone	18	50	920
Asia			
East Asia & Pacific	11	20	118
South Asia	8	18	119
Latin America	9	26	88
Developing countries	14	41	370
Developed countries	22	24	49

Source: World Bank data.

Table 3
Primary school teachers' salaries as percentage of GNP per capita, by region, 1978

	Relative teacher salary
Africa	6.7
West	10.8
East	5.5
Francophone	11.5
Asia	2.5
Latin America	2.4

Source: J. C. Eicher, Educational Costing and Financing in Developing Countries: Focus on Sub-Saharan Africa, 1984, World Bank Staff Working Paper No. 655.

Table 4
Private and social rates of return to education
(In percent)

	Primary		Secondary		Higher	
	Private	Social	Private	Social	Private	Social
Africa	29	29	22	17	32	12
Asia	32	16	17	12	19	11
Developing countries	29	27	19	16	24	13

Source: G. Psacharopoulos, "Returns to Education: An Updated International Comparison," Comparative Education, Vol. 17, No. 3.

There are many arguments for and against reducing student subsidies on equity grounds, but in general those in favor of maintaining them are unconvincing. Equity in education has two objectives. The first, equality of opportunity, means that education opportunities should depend on individual aptitudes and efforts, and not on ability to pay, geographic location, or ethnic affiliation. The second objective, income distribution within society, rests on the premise that, given initial conditions, inequality of income is increased when more is given to those who currently have more.

Improving income distribution clearly calls for abolishing subsidies. As documented earlier, average data for all countries show that the higher the education level (particularly university education), the larger are the subsidies (they are low or zero for primary education). Higher education students are, in fact, privileged in three mutually complementary ways. First, by financing their studies, the community concentrates its resources on a small number of individuals; on average about 20 percent of the resources allocated to education in African countries is concentrated on students who represent less than 2 percent of their age group. Second, higher education students tend, on average, to come from privileged socieconomic backgrounds; in most countries they contain a disproportionately high share of children of civil servants, salaried employees in the modern sector, or urban families in general. Third, these postsecondary students will enjoy higher incomes than average during their active lives and could therefore afford to reimburse the community later for at least part of the financial support they received while they were studying.

The arguments for student subsidies to ensure equality of opportunity rest on the premise that they give access to education to students who otherwise would not be able to afford it. But subsidies are not the only way of achieving equality of opportunity. Leaving aside subsidies that are given to all students, irrespective of their individual or family income status, a student who has difficulty in financing his studies could, instead of a scholarship, receive a loan that would be repayable when he is working and earning a relatively high income.

Overall, therefore, the equity arguments reinforce rather than diminish the efficiency arguments in favor of reducing subsidies to secondary and higher education and transferring the funds to primary education, where they would be used more efficiently and be distributed more widely, to the benefit of less privileged social groups. The arguments in favor of reducing or abolishing student subsidies also apply to the introduction of school charges at the same education levels.

A new policy emphasis on *primary education* is called for. It is important, however, to ensure that, within the differing financial constraints of countries, the allocation of resources between the various types and levels of education is consistent with national goals and social investment priorities. These goals are typically those discussed earlier, that is, to attain maximum efficiency in education expenditure and enhanced social equity both in terms of access to education and income distribution.

In general, these objectives imply that greater emphasis should be placed on primary education. This would be simultaneously economically efficient and equitable. Primary education tends to yield very high social returns, enhances productivity in a wide range of activities, and literacy fosters further learning on the job or during working life in general. More emphasis on primary education—as mentioned earlier—would enhance equity, by increasing opportunities for those who will not receive other types of education; it would also be

socially desirable in many countries, particularly in francophone Africa, which have relatively low levels of primary schooling. It will be necessary, however, to ensure at the same time that the development of primary education does not exert excessive pressure to expand secondary education. Since in most countries the demand for secondary education is high, a dual approach could be taken; secondary school enrollment could be controlled by a price mechanism (increasing the cost of studies, for instance, by reducing subsidies or by introducing school charges) and by offering opportunities for rapid off-school vocational training directly linked to employment opportunities.

The changing economic situation in most countries and the adoption of new production techniques mean that school systems, particularly in technical secondary and in higher education, cannot be rigid and must adapt to changes in job conditions. It is therefore highly preferable to develop a broad technical base and to leave narrow specialization toward the end of formal training. Technical education, as commonly organized, is not only expensive but may, in many countries, be unsynchronized with the specific needs of production, so far as one can judge from employers' statements, employees' salaries, and the absorption of graduates by the labor market. The net result is that the rate of return on any substantial development of formal technical education may not be warranted. Given these reservations, this may be an appropriate time to examine the question of whether formal education is the best way of acquiring very specific job skills or whether these should be provided within an enterprise before and/or during employment.

Reducing costs

Education costs could be reduced by improving efficiency, particularly that of teachers. Reducing costs is a necessity for all African countries but is particularly essential for those with the lowest per capita incomes. It has been shown that for some countries it would be very difficult and a long-term proposition to achieve full enrollment in primary education without a reduction in unit costs.

A priori, two main groups of factors affect unit costs: teachers' salaries and nonsalary teaching expenses—books, materials, and so on. (Welfare expenses are excluded.) Teachers' salaries affect unit costs through average wages and average pupil-loads per teacher. The higher the average salary, the lower the pupil load, and the greater the amount of teaching material used, the higher is the unit cost.

What are the possibilities for reducing unit costs per pupil? It is clearly not desirable to reduce nonsalary teaching costs; these have, in fact, fallen during the last ten years, in relative and in some cases in absolute terms, and are now very low and probably in many cases inadequate. Analyses have even shown that increasing these expenses would have beneficial effects and that their economic efficiency is frequently high.

By contrast, the scope for improving the efficiency of teachers in various ways is greater than it appears at first sight. Average staffing ratios are already high in Africa, particularly in the francophone countries, given available facilities. But fewer teachers would be needed—and costs would be lower—if the facilities were better. Moreover, in many countries pupils have short school days, justified by their age, ability to assimilate knowledge, and attention span. But there is no reason why these short days should also apply to teachers. Depending on the specific possibilities for implementing changes, the number of working days a year or of working hours a week per teacher could be expanded.

Finally, one could consider changes in the pay of teachers. Here again, specific situations will determine which of several different types of measures is most appropriate to achieve changes. The most drastic course would be to decree salary cuts, on the grounds that teachers' salaries in relation to per capita GNP are higher in Africa than in comparable countries, and are particularly high in francophone Africa. However, salary cuts have limitations as a measure to reduce costs. First, and for obvious political reasons, the reduction can only be gradual. Second, it would be easier to reduce teacher salaries if teachers were already well paid compared with similar professionals, such as civil servants. But this is not the case; teachers in francophone Africa are better-paid than their counterparts in anglophone Africa, but so are civil servants in the francophone countries. Third, there is a danger that reducing relative teachers' salaries could reduce the incentives to become a teacher or for teachers to perform as well as possible. An additional, divisive, factor is that the effects of cuts may not be the same among teachers of different disciplines, particularly in secondary education. While the effects can be expected to be limited in the case of teachers of literary subjects, they may be greater in the case of science teachers, for whom competing demand exists in most labor markets. In this connection, the practice of proposing pay scales regardless of relative labor-market scarcities could also be reexamined.

Other possibilities exist for reducing average salary costs per teacher, particularly by altering the qualifications of the teaching body. This concerns a direct trade-off between the "quality" of the teacher, measured by his academic qualifications, and the number of pupils the country can afford to enroll in school within a given financial budget. Thus, while teachers with high academic qualifications are probably better-qualified to exercise their profession, employing teachers with lower qualifications (at lower salaries) would release funds that could be used to increase enrollment. The efficient and equitable use of resources may require a loss in terms of knowledge acquired by individual pupils (because teachers are less qualified) in order to achieve a gain in enrollment within a given budget.

Conscious tradeoffs

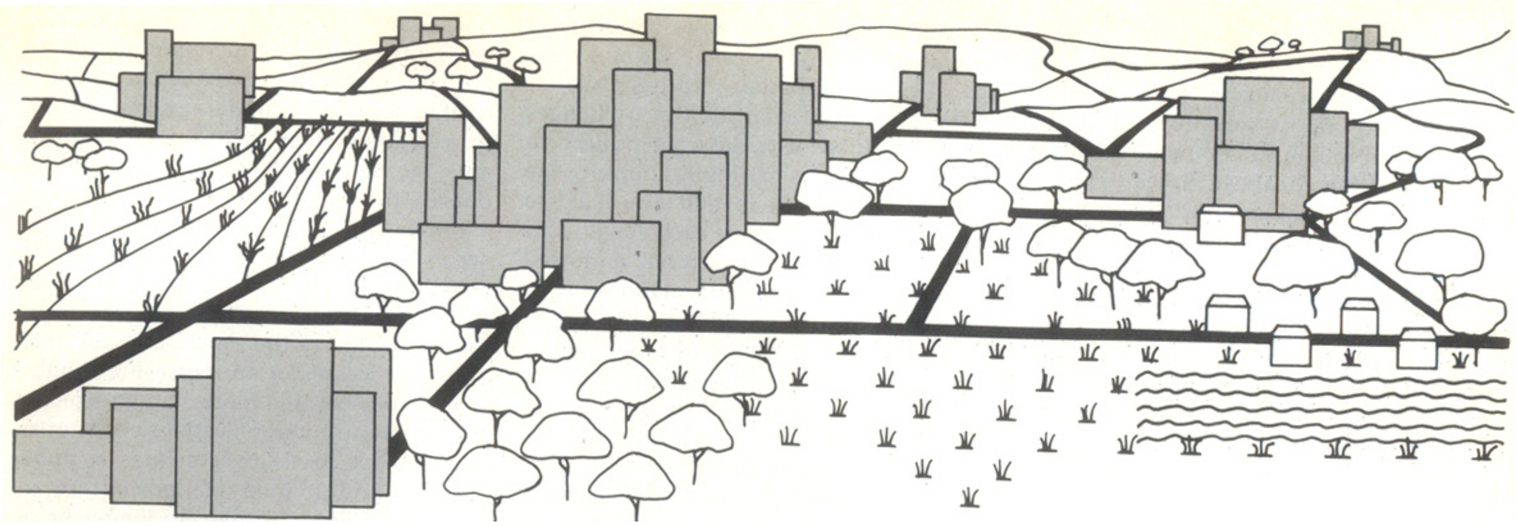
This last point illustrates the difficulty facing educational policymakers in most countries. Every decision involves tradeoffs between highly desirable outcomes. Ideally, one would like to have a higher level of enrollment, better-paid teachers, higher levels of cognitive achievement, and free education. But this review of education in Africa shows that choices among priorities have to be made.

Some of the priorities pointed out in this article may appear politically unacceptable, namely, reducing subsidies for higher education or even the recovery of part of the social cost of education from the beneficiaries. But as our review has also shown, changes in educational financing policies can have desirable effects on a variety of social welfare indicators, including equity. F&D

Alain Mingat
is French and a consultant to the Research Unit in the Education Department of the Bank, where he works mainly on financial and equity aspects of education.

Giuseppe Franchini for F&D

George Psacharopoulos
Greek, is Manager of the Research Program in the Bank's Education Department. His most recent book, with M. Woodhall, is Education for Development: Analysis of Investment Choices *(Oxford, 1985).*



Urbanization patterns in the Third World

How to create a basis for efficient growth

Andrew Hamer

During the final two decades of this century, an estimated 1.1 billion persons will be added to the urban population of the developing world. In virtually all these regions, urban population growth between 1980 and 2000 will match or exceed the existing levels. Urban growth is rather an abstract concept, but the concentration of more people in larger cities is very visible. There are already 125 cities in the developing world with more than one million inhabitants each; these centers have a total population of 355 million. United Nations forecasts for the developing world predict that by the year 2000 the number of cities with more than one million residents will approach 300, and have a combined population of almost one billion.

Third World urbanization is taking place at much lower per capita income levels than those of developed countries in periods when their urban growth was comparably fast. Thus, even in the best of circumstances, planners and policymakers in developing nations face more difficult trade-offs than their earlier counterparts in the industrial world in dealing with urban management issues. These problems are compounded by the weak analytical framework within which decisions on urban management are taken.

Most of the anxiety concerning urban settlement patterns in developing countries is based on the belief that these do not conform to some "optimal" geographic distribution of population. This is generally defined as a landscape covered with a network of small- and medium-sized cities whose size depends on the country's population. These centers, each growing at similar "moderate" rates, would, according to this view, collectively produce at least as much output as would a pattern of urbanization dominated by large cities. The purported advantage of the optimal pattern would be that the rural sector could evolve without the need to shift large groups of workers to large cities. According to this scenario all areas, urban and rural, could be upgraded simultaneously, and public services provided faster and more cheaply than if urbanization were concentrated in large centers.

In the name of this vision of "balanced" urban growth, some economic policymakers advocate regulations and licenses to limit immigration and employment growth in large centers. But the full implementation of this strategy is usually frustrated by competing interest groups within the government, who see in the concentration of urban population and production a powerful potential for cost savings. By increasing production costs, the redirection of activity to smaller centers would, they believe, impede economic growth.

Urban economists maintain that both positions have faulty analytical foundations. The optimum geography school, they argue, misunderstands the determinants and consequences of migration to large cities. By extension, it also ignores the crucial role played by the location decisions of producers of goods and services in shaping city size. As outlined below, large cities grow because it is advantageous to operate many businesses in such an environment. This is true even when such location decisions are evaluated using price signals corrected to eliminate distortions such as subsidies. The decisions of many native and immigrant workers to locate in such cities can be justified, as well. In particular, migrants tend to move from places perceived to have limited economic opportunity to areas where options are broader. These individuals are usually well-equipped to start anew. Once settled, migrants tend to fare as well as their nonmigrant counterparts in the city. Furthermore, their places of origin also benefit, through reduced population pressure and the inflow of remittances.

None of this is meant to deny that rapid city growth is difficult to accommodate. In larger cities, the unit costs of additional infrastructure may be relatively high. Nevertheless, even in such cities, services can be provided, at affordable standards, without drawing on subsidies paid by the nation as a whole.

This does not mean that only large cities are socially efficient in accommodating nonagricultural economic and demographic growth. Concentrationists assume that the clustering of nonagricultural economic activity in a few large cities, which occurs when import-substituting industrialization is imposed on an economy with few suitable locations, would remain the norm even under less distorted macro-

economic policies. But in the general economists' view, the problem lies in condoning policies that indiscriminately pour huge subsidies into import substitutes that are otherwise unprofitable over the foreseeable future. Since the cheapest places to manufacture these products tend to be large cities, where infrastructure, skilled labor, government favors, and markets are most accessible, forced industrialization ends up promoting the premature growth of large urban centers and retarding potential urban growth elsewhere. Such an approach leads to inefficiency because it discriminates against the rural sector, and thus against smaller regional cities, in favor of an industrial development that is often inappropriate over the short and medium term, given the resource endowment of even the most advanced regions of developing countries.

Urban economists advocate a different approach. For them the key questions are whether cities, regardless of size, are effectively managed; whether local authorities can raise resources and tailor expenditures to foster economic development, building on past growth; and whether the macroeconomic environment biases the location of economic activity. In the final analysis, the spatial distribution and concentration of population and production is an outcome of the organization of the economy, as well as of geographic constraints. City sizes and urban settlement patterns cannot be "willed" into being; they are dependent on the economic system.

Stages of urbanization

In most countries, during the early stages of development, the degree of urbanization appears to be closely associated with the rate of economic activity. Rapidly growing economies urbanize more quickly than slowly growing ones; and urbanization responds more immediately to economic growth at low levels of per capita income than at higher levels. In the course of development, there is a systematic shift from natural resource-based activities to secondary (industrial) and tertiary (service-based) ones. These locate in cities and towns for a straightforward reason: productivity is enhanced by the concentration of people and capital. Such "agglomeration economies" that flow from proximity to a source of production are enhanced by technologies that permit increased output per unit of land in secondary and tertiary production.

The size, number, and distribution of cities are also affected by national or regional production patterns, namely, by the tradable goods and services that cities export to other areas, as well as the demand generated for purely local goods and services. The development process that increases overall urbanization also changes the composition of tradables produced in urban centers. This has implications for the types of urban centers that are likely to grow relatively rapidly at each stage.

Assuming a country is well endowed with natural resources and manpower, its urban evolution typically follows a predictable pattern. Early urbanization will be closely linked to servicing agriculture, processing natural resources for regional or international markets, and producing simple manufactures that are competitive with potential imports. Such activities might include mining and agroprocessing, the production of construction materials, beverages, textiles and handicrafts, and the repair and production of simple structures and machines.

At this stage, many of the constraints associated with such an underdeveloped economy are indeed best overcome in the larger centers. They have a relatively large and diversified pool of labor; information is available about new markets or technologies; and more infrastructure is in place than in the less visible, smaller centers. Large centers also generally combine sizable local markets with access to the outside world. Major ports, for example, can generate income from shipments of exports, while making imports available to local producers without exacting a high surcharge for domestic land transportation.

These factors suggest that the leading productive activities of early industrial development will be located in large centers. The exceptions include (1) plants using inputs that are perishable or undergo large weight losses in processing; (2) establishments processing resources shipped directly to export markets; (3) enterprises marketing products at prices competitive with those of products shipped over great distances; and (4) agribusiness and local administrative services. As long as industries can produce substantially more cheaply by being concentrated in a few large centers, the basis for extensive trade between many cities is limited, and the development of rapidly growing, specialized secondary centers postponed.

Assuming moderate competence in the public sector, development constraints should ease in the periods that follow. Production will become more diversified; engineering, metallurgy, and other modern subsectors will appear; and the centers will expand. Metropolitan establishments will create branch plants or transfer their operations to these nearby areas, taking advantage of lower land, labor, and transport costs. Local entrepreneurs in these same emerging, but still dependent, communities will expand their activities, responding to the new opportunities offered by improved accessibility, better public services, and the selective cost savings available outside the major centers.

But the process of growth in self-standing secondary centers will be slower, and depend primarily on local entrepreneurs and investors. Secondary centers will only begin to emerge as the production and marketing processes of an increasing number of activities become more standardized; as transport and communications become easier; and as local investments in public services and trained manpower are increased. There will then no longer be an automatic link between lower production costs and greater city size.

As development proceeds, a variety of industrial firms find that they can be most efficient if they locate themselves with firms producing similar products, in smaller urban centers, where land is inexpensive and labor available at relatively low wages. Improved roads and communications allow these "peripheral" producers to reach ever-wider domestic and international markets. The stage is thus set for secondary centers to specialize in particular types of relatively routine activity, reap the benefits of lower costs associated with the concentration of production within an industry, and trade extensively. Large centers then find new sources of comparative advantage by attracting selected high-growth activities, in many of which production is still cheaper in major cities. These activities involve the production of unstandardized, advanced technology items; sophisticated business services; and goods subject to rapid changes in input or output characteristics. Metropolitan markets also continue to attract a variety of small firms producing consumer goods.

Role for public policy

During the earlier stage of development, when decentralized industrialization is limited by the fact that most economic activity has to be concentrated, it is quite useless to try to force it away from large cities. But as more infrastructure is installed, and experience with industrial processes increases, the encouragement of secondary centers becomes consistent with maximizing national economic growth. To foster the expansion of tradable goods and services in secondary cities—and local activities that respond to that growth—public services must be improved and regional and interregional access enhanced. At one level, this may appear intuitively obvious; better infrastructure reduces the overall costs of

doing business. Less apparent is the important role these improvements play in attracting and retaining highly skilled workers, managers, and entrepreneurs, whose absence can be a critical constraint on the growth of productive activities in secondary centers.

Studies in both developed and developing countries have demonstrated that highly skilled and unskilled labor are rather poor substitutes for each other. This means that the additional production of tradables requires fairly rigid combinations of skills; it is thus constrained by factors in short supply, typically skilled labor. Skilled workers base their decisions, at least partly, on the amenities offered by different work centers. Spontaneous, decentralized growth therefore depends on overcoming the "disamenities" of secondary centers, often by extending and improving public services. As these improve, local businesses can reduce the wage packages they offer to skilled workers. At some stage, the resulting savings may not only allow greater scope for expansion for individual firms, but may even determine the viability of many lines of activity in any given urban center.

Public policies have important effects on the development of particular cities—even where they are not designed to—through attracting scarce skills. Such implicit effects are difficult to measure with precision, since the eventual impact of these policies depends on the even more indirect ways in which factors of production (labor, capital, and land) adjust to them. Some general conclusions can be reached, however, on the most effective policies.

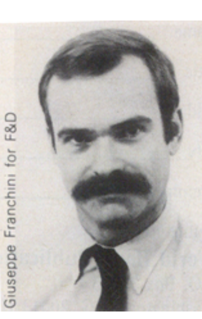
The first is that any measure promoting a given activity will benefit the urban area in which it is located. The requirements of different production processes vary widely across industrial subsectors, as do the supplies of particular inputs across cities. At one extreme, some inputs—such as easy access to an international port or to central government officials—may be available at only a few locations. Policies promoting firms dependent upon such inputs may result in long-term advantages for those urban areas.

As already mentioned, experience in a range of developing countries suggests that most heavily protected activities tend to be located in large urban centers, where they can satisfy their exceptional need for imports, sophisticated factors of production, and access to officials who grant discretionary favors. This effect implies that the greater the bias in favor of import substitution, the greater the incentive to concentrate production and population in a major metropolis.

Clearly, a shift in the emphasis of public policy away from a protectionist trade regime would benefit secondary cities. The full effects of a change in policies would take time to be felt, especially if the overall level of economic development is low. Even if trade protectionism were reduced, for instance, diversified industrialization outside a handful of cities would be constrained by poor access to national or international markets, limited availability of local infrastructure, and a persistently uneven distribution of skilled workers. Nevertheless, reductions in market distortions, implemented primarily to enhance macroeconomic performance, would also help to disperse production geographically over the long run. With reasonably uniform, and relatively low, protection for all sectors, for example, industrial activities would emerge that could provide the basis for the efficient growth of smaller centers. Simultaneously, careful management of the development process would allow for investments that would gradually ease locational constraints. In the long run, more cities would be able to accommodate more producers, and modernization would no longer coincide with growth in one or two centers.

Similar comments could be made about the organization of financial institutions making long-term loans in developing countries. Both cities and the establishments within them must be able to match self-generated resources with loans, to finance long-term growth. Cities are rarely encouraged to compete with one another for access to loans, and most investments are paid for by handouts from the central government, which tends to discriminate in favor of large cities, especially the capital. Business finds that public development banks discriminate in favor of enterprises capable of establishing and maintaining face-to-face contact in the principal financial centers. Because of various institutional restrictions, commercial banks in secondary centers do not fill this void by providing long-term capital. As a result, in secondary cities, all but the very largest firms are frozen out of the market for long-term funds, even when their real returns are high.

These examples illustrate one point: if any individual sectoral policy is ill-advised on macroeconomic grounds, and hampers the development of most urban centers, the latter is one more reason to consider reform. Ignoring the implicit impact of such policies on urban centers means encouraging the selective reinforcement of particular cities at the expense of others, even when there is no efficiency rationale for doing so.


Giuseppe Franchini for F&D

Andrew Hamer
a U.S. national, holds a PhD from Harvard University and is at present an Economist in the Operations Support and Research Unit of the Bank's Water Supply and Urban Development Department.

Effective interventions

At any given time, only a few public initiatives will be possible, and unfortunately, the very conditions that call for remedial action limit the funds and the competent personnel available to implement it. In addition, urban growth is the outcome of decisions by millions of individual households and businesses concerning location; these processes are so complex and so interdependent that policies can do little more than set the broad parameters for such decision making.

For these reasons, the temptation to assign an optimal size to each city as a goal of public policy, and to back that up with city-specific licenses, prohibitions, and subsidies, should be resisted. Experience has shown that the implementation costs of such "direct" approaches are prohibitively high, while the benefits would be small compared with those that would emerge from improved macroeconomic and sectoral policies.

In fact, the relative attractiveness of cities depends most on policies that have little of the gloss and glamor of traditional "spatial" policies. Although there is no quantitative model that can be used to predict the changes in relative city sizes that would be caused by particular policy reforms, the net effect of more efficient macroeconomic and sectoral policies is to encourage more decentralized urban development in the long run. This decentralized development will occur not because it is politically desirable but because it allows the actual growth of national output to approach its potential.

Some recommendations are possible on the basis of an analysis of the potential of and limitations to effective public policy.

- Large dividends can be reaped by gradually improving the access of secondary centers to domestic and international markets. These will reduce the importance of physical proximity to the main consumer markets, which otherwise largely dictates location.

• Improved transport and communications must be accompanied by a reduction in the role played by discretionary incentives, which depend on access to government bureaucrats. These incentives distort production decisions, while encouraging business to locate near the centers of government power.

• Price incentives that encourage economic activities to become concentrated in large cities, especially those incentives associated with international trade regulation, should be modified to reduce the bias against secondary centers.

• A reform of macroeconomic and sectoral policies must include measures that free the rural sector from punitive domestic controls, heavy implicit or explicit export taxes, severe constraints on the use of yield-boosting inputs, and poorly planned systems of credit. A healthy rural sector provides a base for the expansion of firms in secondary cities, while improving overall national growth prospects.

• Government should be encouraged to develop industrial zones and discrete estates only in areas of proven growth or well-documented potential. The opportunity cost of underutilized public investment in industrial infrastructure is so high that developing countries cannot afford to invest to induce firms to move to areas with limited potential. At most stages of development, the areas with potential for industrial growth are clear; elsewhere, the obstacles to growth are such that even radical improvements in infrastructure will not promote it.

• Public industrial investment should not be made to accommodate arbitrary regional dispersal objectives. It can be argued that public enterprises have a special role to play in pioneering the development of nontraditional locations. However, if this is taken to mean that public ventures should indefinitely accept sharply lower profits, such a view is debatable, if not unacceptable. Public ventures should be sited in areas of known development potential, except where the inputs used (e.g. minerals) justify an unusual location.

• Improved access to public services and education in individual urban areas plays an important role in increasing the relative attractiveness of secondary centers over time. To avoid waste, to leverage scarce central government resources, and to direct investments to growth areas, cities should compete with one another for grants and loans. This process of "self-selection" would force localities to make substantial efforts to mobilize resources, both to match grants and to pay off loans.

In the end, spatial patterns of population and employment are the indirect outcome of the policies, geographic features, and stage of development that shape the behavior of households and enterprises. The history of explicit spatial policies demonstrates conclusively that promoting locations to achieve some arbitrary spatial goal is often counterproductive. Instead, policies should ensure a macroeconomic environment that supports efficient and broad-based growth, and back this by a gradual expansion of interregional investments in transportation, communications, local infrastructure, and education. Most city-specific investments should be contingent on substantial local financing; subsidization of the urban sector, or any of its component parts, should be avoided. This approach should effectively moderate the growth of cities whose expansion, at the margin, is costly, and will minimize the subsidization of city dwellers by rural residents. It is with such mundane prescriptions, applied consistently over time, that the spatial constraints on development can be removed without reducing economic growth. F&D

The role of development finance corporations

Experience in India and Korea

Joslin Landell-Mills
External Relations Department, IMF*

Development finance corporation is the World Bank's name for an institution more commonly known as a development bank. Originally designed to complement existing financial arrangements, these corporations have generally been established in developing countries where commercial banks are not able to provide either the longer-term financing needed for development projects or short-term loans to unproven entities that nevertheless have the potential to contribute to growth. Commercial banks in these countries traditionally finance inventories in urban trade and industry. Their loans are generally short term; the borrowers' inventories form collateral; and the recipients of the funds typically have an established financial record. Because these banks are usually risk averse, and do not have the capacity to evaluate longer-term or unusual projects submitted by unproven borrowers, commercial bankers neglect the investment opportunities that could be profitable beyond the short term. DFCs were conceived to meet several needs—to make the long-term loans or equity investment required by a nascent industrial sector; to strengthen national development strategies by investing in rural areas or by improving project appraisal methods; and, no less important, to mobilize long-term investment resources.

This article looks at the Bank's experience with two of its most successful DFC borrowers during the 1970s—the Korean Development Finance Corporation and the Industrial Credit and Investment Corporation, India—to illustrate how effectively such institutions could be adapted to different conditions in an economic environment not always conducive to long-term investment. The Bank has been lending to DFCs since the 1950s, when inadequate long-term credit was widely recognized as a primary constraint on the growth of the private industrial sector in the developing world. The investments suitable for promoting each individual project in the sector were relatively small—and therefore too expensive in terms of cost and staff time—for direct Bank loans. The Bank viewed DFCs as a way of financing a broader cross-section of enterprises than it would otherwise be able to reach. It also saw DFCs as potential catalysts for local development initiatives; through their work with raising resources and stimulating local entrepreneurs it was hoped that they would become a source of innovative solutions to local constraints.

The main contribution that KDFC and ICICI made during the 1970s to working out new solutions to investment problems was probably to instill the discipline of systematic project design and evaluation among their clients. KDFC also introduced novel features in its project design to advance broader development objectives: it attempted to diversify the domestic financial system by introducing instruments to promote resource mobilization, and it expanded its activities in the industrial sector. These activities were particularly appropriate in a country such as Korea, where the financial sector needed to become more flexible and sophisticated to sustain growth in its already very highly developed industrial sector. In India, however, a major constraint on growth in the 1970s was limited purchasing power in the rural areas, and ICICI, while remaining financially profitable, emphasized the promotion of productive industrial enterprise in backward areas. It developed a sophisticated approach toward the economic evaluation of these projects, which in general achieved high economic returns in difficult growth conditions.

Flexibility

It is difficult, of course, to draw general conclusions from the individual experiences reviewed in the illustrative boxes on these two corporations. Many external and often unique factors affected the perform-

*This article was prepared when the author was Assistant Editor of this journal.

ance of these DFCs and could have been crucial in their success. KDFC, for instance, provided scarce foreign exchange to Korea's industrial sector at a time when this was growing at an average annual rate of 14 percent. In addition, both KDFC and ICICI were particularly well-managed and efficient compared with other DFCs, and were able to train and retain staff because there was a steady supply of skilled people within the country available to competing institutions. Few other developing countries are so fortunate. Both ICICI and KDFC, too, formed part of a relatively well-developed financial system, in which they were able to find a role for themselves; they did not encounter the operational problems of DFCs in countries with less mature financial sectors. However, a large part of their effectiveness must be attributed to their own efforts.

In particular, both have demonstrated a consistent ability to adapt to fit the investment needs of the time. Since the early 1980s, like all other financial institutions, DFCs have been affected by a deteriorating economic environment. Largely because of the increasing levels of financial distress experienced by the industrial corporate sector in many developing countries, there has been a marked deterioration in the quality of most DFCs' portfolios. KDFC—which became the Korea Long-term Credit Bank in 1980—and ICICI have faced the same problems, but their difficulties have not been so acute. During the latter part of the 1970s both corporations faced falling demand for foreign exchange and an increasing call for domestic currency loans,

The Industrial Credit and Investment Corporation of India

The Industrial Credit and Investment Corporation of India has had a relationship with the Bank for many years; the Bank was involved in its creation in 1955. The Bank's experience with it, as well as with KDFC, provides a practical example of how DFCs can function effectively in contrasting environments.

ICICI allocates resources to viable projects in the industrial sector. These may be privately owned or have joint government ownership. During the 1970s, the Bank granted loans to the Corporation to support its financing particularly of private productive enterprises in backward areas. This emphasis was echoed later in a shift in the government's priorities toward the development of small-scale, labor-intensive enterprises.

Between 1972 and 1978, industrial production in India was growing at about 5 percent a year, with a sharp increase in 1975–76, followed by a decline in 1977–78. Industrial investment remained fairly stable at 1973 levels, while private sector investment fell after 1975. However, ICICI was able to maintain a steady annual disbursement rate of 14 percent, in concordance with projections. In terms of its contribution to total investment in India, its disbursements fell as a share of investments made by all financial institutions—from a high of about 18 percent in fiscal year 1973 to about 11 percent in fiscal year 1977. But its lending is mainly directed to the industrial sector, and here its share more than doubled over the period—to reach over 10 percent in fiscal year 1977. This is primarily the result of the combination of its own high disbursement rates and sluggish national investment.

ICICI did not engage in activities in securities and capital markets in a major way, but it promoted new enterprises by underwriting or direct subscription—providing, on average, almost 13 percent of disbursements in these activities by all financial institutions during the 1970s.

Financially, the Corporation's performance was better than expected. Net profits as a percent of equity were, on average, 12 percent between 1971 and 1977, while they were projected to be about 10 percent. It increased its lending and dividend rates in line with its profits and was able to redeem some debts two years ahead of schedule in 1975. In general, its debt/equity ratio was kept within its contractual limits. However, total arrears increased almost threefold during these years, mainly because of some 35 problem companies—in the metals and electrical equipment sectors—which were badly affected by the oil crisis and the subsequent business recession in India. But these problems were manageable and did not have a serious impact on the Corporation's portfolio. Its profitability also testifies to its capacity for sound project evaluation. Consistent with its emphasis on development work, ICICI was the first DFC associated with the Bank to use systematically advanced economic evaluation methodology. It has a particularly good record in appraising large-scale complex projects.

It was also able to diversify its sources of foreign exchange somewhat, and was successful in raising domestic currency by obtaining a government guarantee on two 15-year bond issues. ICICI has always accounted for the bulk of foreign exchange disbursements made by India's financial institutions, but during the 1970s the share of its rupee disbursements rose from being about 28 percent of its total investments to represent almost 46 percent by fiscal year 1978. This increase was due mainly to the fact that more domestic goods were available to local enterprises, and also that they had alternative sources of foreign exchange.

The efforts made by ICICI to increase its promotion of projects, particularly in backward areas, led lending to these regions to increase by almost 30 percent of its total approvals between 1955–70 and 1974–76, some 6 percent of the total financing going to new entrepreneurs. Out of the 392 projects financed during the 1970s, 60 were new, and 63 were in backward areas. However, ICICI does not lend to small-scale enterprises; these are financed by institutions specifically catering to them.

Economic conditions in the 1970s in India were not particularly conducive to profitable long-term investments: growth in industrial production was sluggish; investment rates were low; and general conditions were not such as to promote enterprise. ICICI's problems with arrears, implementation delays, and cost overruns reflected those conditions. Furthermore, it was not easy for ICICI to diversify its sources of foreign funds. In spite of these disadvantages, ICICI's profitability was high, its investment levels well above average for similar national institutions, and its efforts to promote industrial enterprise in backward areas were sustained and sustainable.

as more firms needed domestically produced equipment. ICICI was able to respond, and its domestic currency lending became an increasingly important part of its portfolio. KDFC was initially precluded by its charter from mobilizing domestic currency resources (except in the form of equity), but since its transformation into a long-term credit bank, it can issue long-term domestic currency debentures and accept domestic currency deposits from corporate borrowers. The share of domestic currency loans in its total loan portfolio has risen substantially. Both corporations have changed materially since 1980, as the need has grown to diversify their sources of funds and the scope of their operations.

In spite of their different functions, and the differing economic environments in which they were pursued, the two DFCs discussed demonstrate some important common features which have a bearing on how institutions such as these can continue to play a role in the development process. The Bank first supported DFCs as a way of reaching the small entrepreneur and providing what was then the industrial sector's most scarce and most needed resource—foreign exchange—a resource that DFCs supported by the Bank had privileged access to. But as their domestic capital goods sectors grew, many of the inputs needed by borrowers began to be produced locally, and both ICICI and KDFC were able to expand their domestic currency borrowing and lending. This flexibility was an important factor in their capacity to maintain a high level of operations (and profitability) since the 1970s. F&D

The Korean Development Finance Corporation

The Korean Development Finance Corporation was established in 1967 as a privately owned corporation to accelerate industrial growth by providing long-term finance to private manufacturing enterprises. Until 1980, when it became Korea's first long-term credit bank and was authorized to expand its domestic currency lending, KDFC dealt almost exclusively in foreign currency long-term loans, and investments. During the decade that followed its creation, the Korean economy was growing at about 10 percent a year, and the export-oriented manufacturing sector at 18 percent a year, supported by an annual gross capital investment of about 12 percent a year in real terms. Commercial banks were, and continue to be, the principal institutional source of funds to the private sector; KDFC was a major provider of long-term foreign exchange financing to medium- and large-scale private enterprise that did not receive government funds.

During the 1970s, the Bank made five loans to KDFC to meet the corporation's foreign currency requirements over the period. The Bank's experience with these loans provides a useful illustration of the ways in which KDFC was able to experiment with promoting manufacturing, albeit in a booming economic environment, and remain financially profitable. Each loan had a slightly different emphasis; the first ones aimed primarily to ensure efficient allocation of scarce foreign resources to private business and to strengthen the institutional side of KDFC, particularly its economic analysis. With institutional strengthening achieved, the next loans stressed the Corporation's development potential—to expand export-oriented enterprises, to deepen and strengthen the financial system, and to promote small entrepreneurs in the business of producing machinery and agro-industrial products in less developed areas.

Between 1971 and 1979, the corporation used its Bank funds to invest in 146 projects (108 of these investments were for the expansion and modernization of existing firms). Few had cost overruns, and most were completed on time. In their first year of operation, 42 had losses and 24 of these ran at a loss in their second year, but by 1979 most were financially sound and none were in arrears. These projects created a total of 12,950 jobs, and generated returns and exports well above estimates. The export-oriented textile industry received 20 percent of the loans made, and, in line with government priorities, machinery, deep sea fishing, and marine transport received significant shares.

The success of its lending to projects reflected the Corporation's sound appraisal and evaluation capacity. This is also evident in its ability to raise foreign resources; between 1969 and 1979 it mobilized $561 million, about 79 percent from official sources, although its reliance on these is rapidly decreasing. KDFC's net income rose by 25 percent annually between 1971 and 1979, and paid a return on equity of about 17 percent a year (although the effective rate is much lower given the 6.5 percent devaluation of the won against the dollar over the same period). It should also be noted that KDFC was able to increase its share capital through offerings in the market during this period. Perhaps the greatest achievement of the Corporation in terms of efficiency was to reduce its operational expenses from 2.4 percent of assets in 1971 to 0.9 percent in 1979.

Profitable operation is clearly a *sine qua non* for an enterprise's existence, but to perform its proper function, a development finance company has to play more than a financial role. After 1975, KDFC had a developmental strategy which it pursued in an innovative and highly successful way. To draw more enterprises into the financial net, KDFC helped to establish a leasing company to purchase foreign and domestic manufactured equipment and lease it to firms that could not otherwise afford it. The Corporation also cooperated with some of Korea's regional commercial banks to increase the funds—particularly in foreign currency—available to small enterprises in rural areas. To promote technology development, it helped to found a firm that assists ventures using technical patents and processes developed by another company supported by KDFC. To diversify the financial system, it helped to establish an institution to handle short-term credit transactions—an innovation that led to the establishment of 15 other short-term financing companies between 1973 and 1979. By the end of 1979, these companies had mobilized 765 billion won (about $1.6 billion) in discounted notes.

Although KDFC only accounted for 23 percent of total fixed investment in Korea's manufacturing sector between 1971–78, it created 44,600 new jobs out of a total of 1.7 million in that sector. Its ability to innovate in the financial sector, and its efficient operation clearly had a greater impact than the size of its investments would indicate.

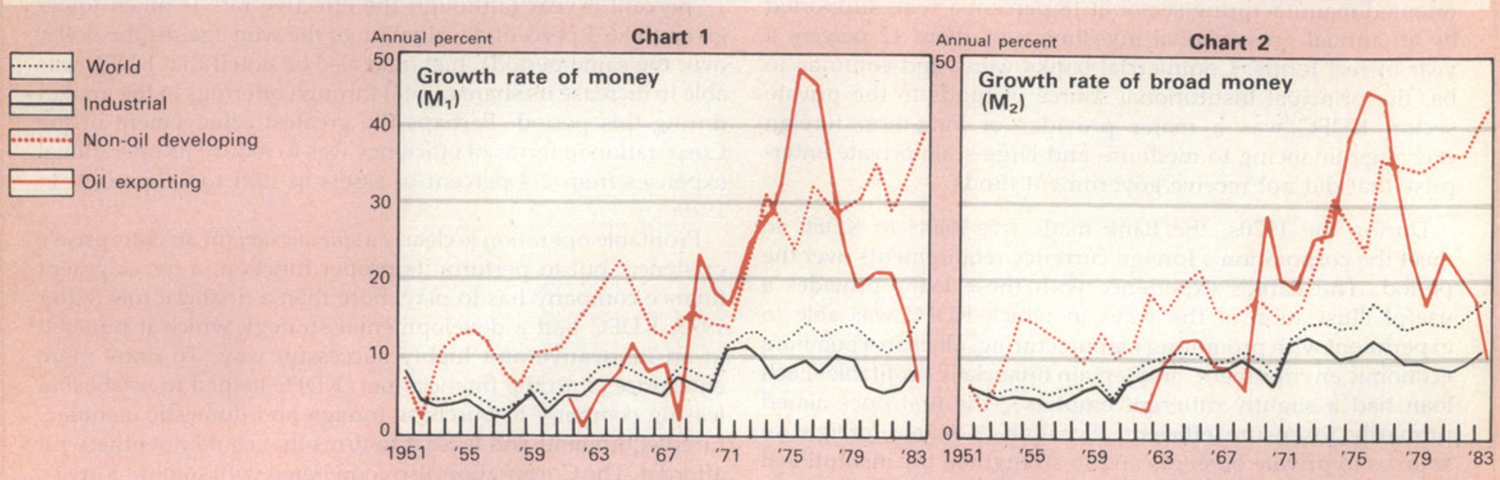
Money, 1951–83

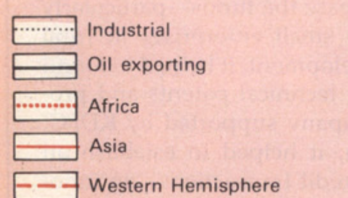
The financial system can have an important influence on the real sector of any economy, and the behavior of the monetary aggregates is a valuable indicator of conditions in the economy, as well as a guide for setting macroeconomic policies. Charts 1 and 3 use a narrow definition of money (M_1), which comprises the financial claims that can be used as a means of payment, *viz.*, currency held by the public and demand deposits in central and commercial banks. This measure is called money in *International Financial Statistics*. Charts 2 and 4 use a measure of broad money (M_2) that includes the time, savings, and foreign currency deposits (often referred to as quasi-money) of those same institutions in addition to deposits included in money. As can be seen from comparing Charts 1 and 2, broad money has almost invariably grown faster than narrow money, although the growth rates of the two magnitudes have displayed similar features.

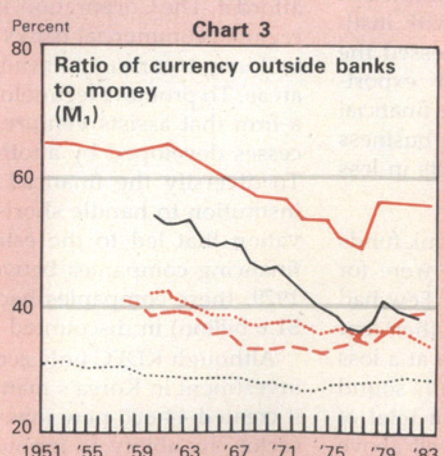
During the 1950s and 1960s, both the industrial and developing countries experienced roughly similar moderate upward trends in the growth of both monetary aggregates. The growth rates for all groups increased further in the early 1970s, but from about the mid-1970s, the monetary growth rates for the industrial and non-oil developing countries became increasingly divergent. In the period covered by the charts, the gap between these two groups was greatest in 1983.

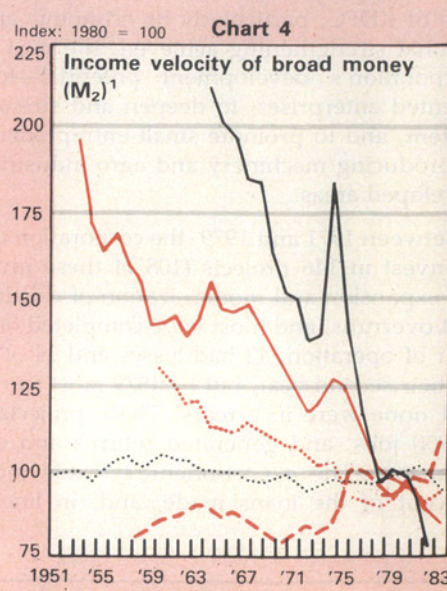
Developing countries generally have a high proportion of the means of payment (M_1) held as currency, although there has been a downward trend in this ratio over the 33 years covered by Chart 3. In 1983 the ratio for non-oil developing countries was 43 percent, compared to 28 percent for the industrial countries.

The income velocity of broad money in Chart 4 shows the trends in the value of transactions financed by a unit of broad money. The stability of this ratio for industrial countries does not show the substantial decrease in the relative size of narrow money compared with quasi-money. With the exception of the Western Hemisphere countries, developing country groups experienced a downward trend, which was influenced by growth in the size of the monetized sector. In the case of some Western Hemisphere countries, high inflation and controls on nominal interest rates contributed to the overall rise in velocity of broad money for this group.









Sources: IMF, *International Financial Statistics: Supplement on Money*, 1983 and *Yearbook 1984*.
Notes: The country groupings used in these charts are derived from *International Financial Statistics*. Not all countries may be used in the calculation for all periods and for all series. Currency, money, and broad money are annual averages of monthly data. The derivation of all series is more fully explained in the *Supplement on Money*.
[1]Ratio of gross domestic product (or if not available, gross national product) to broad money.

Thinkers and doers

A review of two recent books on development

I.M.D. Little

Gerald M. Meier and Dudley Seers (editors)

Pioneers in Development

Oxford University Press for the World Bank, New York, 1984, x + 372 pp., $29.95 (cloth).

Stanley Please

The Hobbled Giant

Essays on the World Bank

Westview Press, Boulder, CO, USA, 1984, xi + 99 pp., $12.95 (paper).

Pioneers in Development contains papers by ten pioneers of postwar development economics; these were the basis of a lecture series given at the invitation of the World Bank. The ten, Lord Bauer, Colin Clark, Albert O. Hirschman, Sir Arthur Lewis, Gunnar Myrdal, Raúl Prebisch, Paul N. Rosenstein-Rodan, W.W. Rostow, H.W. Singer, and Jan Tinbergen, were asked "to reassess the main themes of their early work and to reconsider their assumptions, concepts, and policy prescriptions in relation to the way the course of development has proceeded since their pioneering days in the 1940s and 1950s." The volume also contains a substantial introduction and postscript by Gerald Meier and Paul Streeten, respectively.

Each pioneer's paper was reviewed by one or two of the following "contemporary" critics, Michael Lipton, T.N. Srinivasan, Graham Pyatt, Carlos Diaz Alejandro, Paul Streeten, Arnold Harberger, Hla Myint, Albert Fishlow, Jagdish Bhagwati, Dragoslav Avramovic, Gerald Helleiner, Azizali Mohammed, Bela Balassa, and Michael Bruno. I was surprised to find Myint in this second list rather than among the pioneers.

Some of the critics took the easy path of paying homage and avoiding the issues. But Lipton made an interesting analysis of Bauer's work. Harberger, on looking into Lewis' work, found that Homer nodded. Streeten gently chided Hirschman, while Myint and Mohammed were a little firmer with Myrdal and Rostow respectively. Balassa was definitely rough with Singer—justifiably so in my opinion.

Among the pioneers themselves there was very little indeed of the reassessment or reconciliation called for. Autobiography and the history of their own and others' thinking, together with reiteration and defense of their own ideas, occupied most space. The former is more interesting than the latter. There were only very few confessions of error or poor judgment. Bauer did not realize how deeply economic life would become politicized, while Lewis thought the biggest mistake he and many others made was to underestimate population growth. Nothing to be ashamed of!

There is fortunately no room for me here to embark on an analysis of the pioneers' ideas. I have already critically considered such concepts as surplus labor, the big push, balanced growth, stages of growth, protection and import substitution policies, trendy terms of trade, linkages, and development planning in a recently published book (See box—Ed.), and there made it clear that I felt these notions were, on balance, counterproductive. They naturally recur again and again in the present volume, apart from Bauer's and Clarke's contributions, but I do not want to shoot again. I am not, of course, suggesting that the pioneers had no useful insights, but the most seminal in terms of the influence they had were also (arguably, of course) the most misleading.

A few of the pioneers give us some glimpses of their current thinking. Prebisch finds that democracy and capitalism cannot be combined, not in the South anyway. The not very new argument seems to be that peripheral capitalism by distributing incomes very unequally also creates such an economic conflict between powerful groups that the country becomes democratically ungovernable. But, as Fishlow says, the Southern

I.M.D. Little, Emeritus Fellow of Nuffield College, Oxford, is at present Consultant to the Bank's Development Research Department. His recent book, *Economic Development: Theory, Policy, and International Relations* (Basic Books, 1982), was reviewed in the June 1983 issue of the journal.

Cone is not generalizable. Perhaps he should have added "except for the United Kingdom."

Myrdal has changed his views on aid. It must go as directly as possible to increase the supply of basic needs, and none be given for any industrial project. He may find some support in different parts of the World Bank for both propositions. It should be firmly policed and not be given by established aid agencies, presumably because they have been contaminated by those corrupt elites of the developing countries that have caused Myrdal to change his mind. He may not find much support for this latter proposition in any part of the Bank.

All in all I do not think the present volume is a significant contribution to the literature on economic development. It should be seen more as a contribution to the history of economic thought. But one wonders whether such history is best written by those who did the thinking. I turn to *The Hobbled Giant*, a much shorter and more currently relevant work.

Stanley Please, who was for 20 years on the staff of the World Bank, believes that quite radical reform of the Bank is desirable. Under its Articles of Agreement the Bank is required to lend for projects, except in special circumstances, and this has restricted nonproject lending to a small percentage of the total. But however good the Bank is at its project work, Please considers that its *comparative* advantage now lies in inducing policy reform in developing countries. Project work does not give the Bank much leverage over general economic or even sectoral policies. The new structural adjustment (nonproject) loans, designed to address the special circumstances of the 1980s, should be a model for the future, quite apart from any special present need to disburse money quickly. Even for the longest-term development lending, policies should be brought center-stage.

I have no quarrel with Please's contention that developing countries' economic policies very often seriously conflict with their own objectives, and that this is likely to persist. It is, I think, much more debatable to what extent the Bank, even after changing its mode of lending to secure more leverage, is likely to be effective in promoting desirable policy changes. It is curious in this connection that Please is at pains to point out that the Bank provided only about 3 1/2 percent of the financing for developing countries in 1982, but that he refers to it as a giant in his title and frequently also in his text. It is also curious that he does not mention that the Bank is most unlikely to be able to promote reforms by exercising leverage over large countries. Some smaller countries might also be recalcitrant. If the Bank were to lend only to countries where it was thereby likely to have a beneficial influence over economic policies, it could become an even smaller giant.

Please's second main but related theme is that exchange rate policy is the prerogative of the IMF. Yet it is essentially related to structural reform, which is more the concern of the Bank. Structural reform is needed where the IMF is not involved; and where the IMF is involved, cooperation with the Bank is often inadequate. Please's solution is that the Bank should be the lead institution for certain countries at certain times, especially when demand management is not top priority.

Please raises very important issues. He discusses them in a frank, appealing, and authoritative manner. Readers not very closely involved with the Bank will learn a lot. His solutions are, however, highly debatable. For the Bank they would imply large changes of staff, and improvements in economic and diplomatic expertise, as Please recognizes. Most developing country governments would furiously oppose the massive increase in surveillance that is implied. But, though highly debatable, they certainly need debating. It is a pity that quality of publication was sacrificed for speed; the "print" is tiresome to read.

Samuel Brittan

The Role and Limits of Government

Essays in Political Economy

University of Minnesota Press, Minneapolis, MN, USA, 1983, 280 pp., $37.50 (cloth), $14.95 (paper).

The pendulum of prevailing opinion about the role of government in economic matters has swung far in the past decade. From the end of World War II until well into the 1970s many regarded an interventionist role for government as almost axiomatic. In developing countries government was seen as the prime mover of development, entrepreneur, and chief planner. In industrial countries, government was viewed as the promoter of key socio-economic goals (such as price stability, full employment, income distribution) and, in a few countries, as an active force in the allocation of resources.

In the past few years a fundamental reassessment of the role of government in economic life has been under way, coinciding with, but not limited to, the coming to power of governments with a more market-oriented philosophy. This has entailed a retreat from Keynesian (or supposedly Keynesian) ideas on the theoretical plane and, on the practical side, a greater degree of market freedom as reflected in marked deregulation in certain countries.

Brittan's book is a most welcome contribution to the continuing debate concerning the role and functions of government. He belongs to a rare, if not endangered, species: an economist who views the discipline essentially for the contribution it can make to better policies, a clear thinker, an elegant writer, and a wide reader familiar with the sister disciplines of economics. In short, a political economist. The essays in this volume range over a fairly broad field, from a discussion of utilitarianism and a consideration of Hayek's ideas to the so-called British "sickness." As is normally the case with collections of essays, their appeal and attraction will vary according to the reader's interests. This reader found the two aforementioned sections enjoyable, while, for instance, the opening chapter on the Wenceslas Myth seemed rather obvious. Of particular importance is the nature of the government's role in the context of an increasingly integrated international economy, in particular the exogenously imposed limits on government's role in the domestic economy. Alas, while Brittan's chapter on international developments ("Economic Stress in the West") offers a synthesis of recent trends, this topic merits a much fuller treatment.

Brittan's own ideas about the role of government, explicitly and implicitly stated throughout the book, occupy essentially the middle ground, though, seen in the context of postwar orthodoxy, they would lean to the political right. For Brittan, there are certain economic functions that the government should fulfil, but there are also strict limits to what government *can* do, and governments that ignore such limits—particularly with regard to expenditure—are often rewarded by intractable inflation for their efforts.

This collection is highly recommended for all those, professional and laymen alike, interested in economic policy.

Bahram Nowzad

David Suratgar (editor)

Default and Rescheduling

Corporate and Sovereign Borrowers in Difficulty

Euromoney Publications, London, 1984, viii + 163 pp., $85.

Dr. Johnson once said that soon it would be impossible to read all the books that were published, to which one could add in these days: on international debt. The book under review is a useful addition to the library on debt because it considers practical aspects, including many legal problems, of default and rescheduling. The book is a collection of 19 chapters, as well as preliminary material, each written by a different author. The authors are bankers, lawyers, and officials, both international and national. Most of the authors are American or English, with practical experience in their native countries. The collection is based upon two conferences held in 1981 and 1982. The editor explains that his objective was not to produce a systematic or comprehensive treatment but to highlight the major practical and legal issues in international and corporate defaults and debt rescheduling. Even so, the objective is ambitious. It should be emphasized that the subject matter includes both corporate and sovereign borrowers in difficulties.

Most of the chapters are brief, sometimes extremely brief, and probably the constraint of space explains why, for the most part, they present broad topics and little detail. The chapters that consider the concept and treatment of default, conflicts of national laws in multinational bankruptcies, and the role of the Fund are examples of this approach. A few chapters, however, including those on security in international lending, the subordination of foreign claims under Argentina's bankruptcy law, special risks and remedies under international sovereign loans, and documentation, do deal with more specific topics and provide more detail.

On the whole, the book is likely to appeal more to the nonspecialist who wishes to learn something about a special feature of international debt than to the practitioner already in the field. A virtue of the book is its treatment of the case histories of Nicaragua and Costa Rica and of a nonsovereign power called Chrysler. Another virtue is the attempt in various chapters to recognize the role of international organizations like the Fund and the Bank. More should be made known about the activities of these organizations.

In the brief period since 1982, much has happened that affects the subject matter of the book, including the new arrangements for Mexico's indebtedness, the International Lending Supervision Act 1983 of the United States, and litigation on financial problems already decided and under appeal, particularly in the United States. It is somewhat surprising to note, in a collection devoted so heavily to legal issues, that no space is found for the judicial treatment of the exchange control regulations of foreign countries and defenses of the Act of State and sovereign immunity.

Joseph Gold

William R. Cline

International Debt

Systemic Risk and Policy Response

Institute for International Economics, Washington, DC, 1984, xix + 317 pp., $25 (cloth).

As Sir Joseph Gold implies in another review, the literature on international debt is reaching saturation point. The broad aspects of the debt problem—causes, cures, prospects—are by now well known and have been much debated. Currently in fashion is the formulation of grand schemes designed to slay the debt monster once and for all.

Cline's book is, nevertheless, welcome for a number of reasons—the main one being that it presents a clear, focused, and balanced synthesis of the principal issues, buttressed by historical narrative and lucid analysis as necessary, and peppered with more than a few fairly sweeping statements.

The multiple origins of the debt problem are efficiently analyzed in Chapter 1, although by page 143 Cline states flatly that: "The root cause of the current debt problem is global recession." It naturally follows that the solution is global recovery or, to be more precise, a "crucial threshold" for industrial country growth of 3 percent in 1984–86. The situation, however, is more complex: as anyone who has dealt with debt problems firsthand knows (and as the book as a whole demonstrates), economic recovery is a very important ingredient, but many other things have to go right before we are completely out of the woods. In general, Cline is reasonably reassuring regarding future prospects, a welcome contrast to the gloom of other analysts.

Regarding the recent approaches to the debt crisis, Cline clearly favors the case-by-case approach, with all parties—the debtor country, the banks, the Paris Club, and the IMF—making their contribution. He appreciates and supports the role of the Fund: "It acted as a highly effective coordinator capable of marshalling joint action that the large banks by themselves would have had much more difficulty in securing." Not surprisingly, he is not attracted to generalized schemes, believing (correctly, in my view) that their drawbacks outweigh their advantages.

If Cline is obsessed by one issue, it is whether the debt crisis is one of illiquidity or insolvency: for him it is "the most fundamental policy issue," and reading the book, one is never very far from it. Whatever one may be able to do in theory, as a *policy* matter the issue is not so clear-cut: when (and after how long) does a liquidity problem become one of insolvency? Who decides? In practice is it not a largely subjective matter? If indeed the distinction between illiquidity and insolvency is to a large extent a matter of perception, is it not, then, of limited use as a cornerstone for policy decisions?

In addition to the above topics, the book has interesting chapters on debt dynamics, the medium-term outlook, and banking institutions. For model addicts, Appendices A and B provide entertainment, although due care is recommended in playing with models in this area. Appendix C provides sketches of five actual debt crises.

Altogether a most useful and impressive work.

Bahram Nowzad

Serge Michailof

Les apprentis sorciers du développement

Economica, Paris, 1984, viii + 266 pp., F125.

Serge Michailof, an economist, sociologist, and financial analyst, as well as development practitioner, has authored a book that is a timely, subtle, and penetrating analysis of rural development issues in Africa.

Rural development failures originate, Michailof argues, in the inappropriateness of technical, institutional, and policy choices. The inappropriateness results not so much from lack of knowledge as from governments' general distrust of the rural population, their desire to ensure bureaucratic control, and their belief in the myth that low agricultural prices are necessary for economic and social development. Governments, encouraged by international engineering firms, are likely to give preference to large-scale investments in the hope of securing a technological and institutional

solution. The book includes a number of well-chosen and lively case studies, which the author examined first-hand in Benin, Tanzania, Senegal, and Algeria. Of particular interest is the case of the Ivory Coast, where grandiose but unmanageable sugar, palm oil, and coconut development plans are contrasted with India's successful promotion of an intermediate sugar production technology.

The book's recommendations are not new, though the author's merit is to underline that their implementation will require major changes in attitudes and power relationships between urban and rural areas, particularly greater participation by rural people in the decisions affecting them.

This book draws on development literature in both English and French, is written without jargon, and should be particularly helpful to those within and outside Africa who are looking, once again, for ways to improve its future.

Francis Lethem

John H. Jackson, Jean-Victor Louis, and Mitsuo Matsushita

Implementing the Tokyo Round

National Constitutions and International Economic Rules

University of Michigan Press, Ann Arbor, MI, USA, 223 pp., $18.

This book would be of great value even if the current campaign for another round of trade negotiations were not occurring. The three authors are American, Belgian, and Japanese law professors of considerable distinction. Three chapters are written from the perspective of United States, European Community, and Japanese law. In addition, an opening chapter on the general topics of law and world economic interdependence and a concluding chapter on national constitutions and the international economic system have been written by the three authors jointly. The study is based upon the agreements that emerged from the Tokyo Round.

The theme of the book is the constitutional and other legal constraints and the lines of authority for negotiating, accepting, and effectuating international trade agreements under the legal systems of the three principal trading areas. The fact that the three legal systems differ from each other in fundamental features makes the study even more interesting.

Case studies give the book concreteness, but the authors draw lessons from the material that have a pertinence for the creation of an international economic order of greater breadth than the order now in existence. The authors point out that the creation of such an order will not be possible unless the negotiators take cognizance of the legal, political, and economic framework within which they must work, although the book is concerned principally with legal systems.

Much that the authors have written about trade would apply to monetary matters as well. Take, for example, the discussion of the division of constitutional authority in trade matters between the parliamentary and executive branches, and dwell upon recent U.S. legislation on monetary matters.

The authors draw deductions and make recommendations for future negotiations. An interesting recommendation is that governments should be willing to accept a mechanism by which individual citizens or firms could appeal directly to an international body like the Contracting Parties to the GATT to determine whether a government has acted inconsistently with its international obligations on trade. The authors are not confident about governmental willingness to accept such a recommendation.

The book is an excellent and original work, clearly written in language that does not become inspissated with the jargon of any of the disciplines that are relevant to the study.

Joseph Gold

Ezra Solomon (editor)

International Patterns of Inflation

A Study of Contrasts

The Conference Board, New York, 1984, ix + 278 pp., $35.

The experiences of eight major industrial countries—Canada, France, Germany, Italy, Japan, Switzerland, the United Kingdom, and the United States—dealing with inflation during 1965–83 are the subject of this collection of articles. The opening piece, a long discussion of developments in the United States, works from a hypothesis that might be open to dispute. It assumes that "The economic history of the past 15 years has been dominated by two major developments. Both were global in scope and both had global impacts." The first of these, of course, was the 1,500 percent increase in the price of oil between 1972 and 1980. The second was the rapid increase in the U.S. rate of inflation. The essay draws no firm conclusion as to the cause of this inflation, rather it claims that the true causes lie somewhere between the analyses offered by the monetarist and the cost-push schools of thought. Though this may be true, it is not an especially interesting conclusion.

The remaining essays focus on each of the eight countries in three distinct inflationary periods. The belief is expressed that in the first of these periods, 1965–69, U.S inflation was caused by expansionary fiscal policy and a corresponding monetary program. In the other countries of the survey, institutional pressures are blamed for increased inflation. For the second period of inflation, 1972–74, it is claimed that the price increases were not caused by "...the large jumps in oil prices that occurred in December 1973. Oil prices did worsen inflation everywhere in 1974, but the inflationary wave itself was fully under way....The real cause of the 1972–74 wave of inflation was a global expansion of the money supply. The cause of this expansion, in turn, was the ill-advised way in which the major countries of the world handled the dollar devaluation in 1971–73."

The statement is typical of the book's tendency to generalize; relationships are often drawn between causes and effects, with very little supporting evidence. In discussing the third period of inflation, for example, the rise in food prices in 1977 is said to have been responsible for the initial increase in inflation of the Carter administration—a conclusion that seems overly simple, and seems to confuse cause and effect. The book is also studded with platitudes, particularly in its discussion of prospects for the future. In short the book is useful for its descriptive history of the inflationary experiences, but it is considerably less useful as an analysis of the causes of these experiences.

Andrew Feltenstein

Jacques Lecaillon, Felix Paukert, Christian Morrisson, and Deimitri Germidis

Income Distribution and Economic Development

An Analytical Survey

International Labour Office, Geneva, 1984, ix + 212 pp., $15.

The observation that the benefits from economic growth are not necessarily shared by all groups within a country led, during the 1970s, to increasing policy concern over issues of equity. This prompted major research efforts, many of which were conducted by and under the auspices of international agencies. This book summarizes the research that was done in conjunction with the World Employment Programme of the International Labour Office, as well as some related research done elsewhere.

The starting point is the proposition by Simon Kuznets that inequality in income distribution tends to increase when a nation embarks on the process of development but in later stages decreases as the benefits from development become more evenly distributed. Empirical tests of this proposition generally rely on a cross-sectional sample of countries. The intercountry data are difficult to compare, since they pertain to different time periods, income concepts, and segments of the population. Several of the estimations are therefore rightfully criticized and the book's early chapters survey the problems and the proposed solutions. Ultimately, the ILO sets out to "adjust" income distribution data for 40 countries to make concepts and coverage as comparable as possible. Although no econometric estimates are presented, the adjusted data are claimed to confirm the Kuznets hypothesis. However, the paucity of data necessitates the use of rather untested assumptions for many of the adjustments, leaving open the question just how much closer to the "true" distributions the adjusted figures are.

Chapters 3 and 4 scrutinize the factors that contribute to inequality and its change along the Kuznets path. The structural dualism in a developing economy and the associated rural-urban income disparity are shown to be of fundamental importance. Also important is the intrasectoral inequality. Within rural areas income distribution is closely tied to land holdings, and over time is affected by the degree to which the rural sector is integrated with the market economy. Within the urban sector, the major causes for the widening intrasectoral income disparity are the inflow of poorly qualified migrants and the development of a technologically advanced modern sector. The inequality of personal and household incomes is also affected by demographic and socioeconomic factors on income distribution. The disparities among socioeconomic groups can account for 60 to 80 percent of the inequality of incomes in many developing countries.

The final chapters turn to policy instruments and describe tax systems and redistributive government expenditures in a number of countries. Empirically, the redistributive effect of these instruments appears smallest where the inequality in the primary income distribution is greatest. The most progressive transfers are found to be expenditures on primary education, health, social welfare, and social security. Expenditures on higher education appear the most regressive.

The book concludes with some suggestions on how to increase the revenue from direct taxation and how to make indirect taxation and government expenditures more progressive. The authors rightly emphasize the need to investigate the links between instruments as well as the impact that these instruments will have on the structure of demand and production.

This book is concise and clearly written, with a minimum of technical language. For policymakers, researchers, and others with an interest in distributional issues, it presents a valuable survey of an important part of the research undertaken over the last I5 years.

Christiaan Grootaert

Patrick and Sylviane Guillaumont

Zone Franc et Développement Africain

Economica, Paris, 1984, 337 pp., F98.

This clearly written and well-organized book describes the workings and evolution of the franc zone, and provides some statistical evidence of its impact on the economic development and the key sectors of the economies of its member countries.

The book finds that, on the average, the franc zone members have performed somewhat better than other African countries and developing countries in general; they have, to date, coped with the oil shocks, worldwide inflation, stagflation, economic recessions, and external debt. Flexibility has been the key to this success. The franc zone has been able to evolve, especially in 1972–73, while preserving the basic foundation on which the entire system rests: the convertibility of members' currencies and the existence of the operation account (*comptes d'opérations*) with the French Treasury. The authors argue that the franc zone would not have succeeded had member countries not allowed it to maintain a monetary discipline that harmonized their banking structures and fostered cooperation during crisis. On the critical issue of whether the franc zone currency is overvalued, the book presents persuasive statistical evidence to show that for the large majority of members, on average for the ten years ending in 1981, there was no significant overvaluation.

Notwithstanding some adverse developments prompted by the monetary union—such as negative real interest rates, which have considerably discouraged domestic deposits and fostered external borrowings—participation in the franc zone has provided financial stability to its members and has, on balance, benefited their economies. Even though some member countries, especially non-oil exporting countries, have faced some deterioration in their external current account deficits, they have managed to avoid spiral inflation and hyperinflation and balance of payments crises by recourse to the operations account and by borrowing abroad. The book emphasizes that external borrowing has been greatly facilitated by membership in the franc zone and by the convertibility of the currency. Moreover, the zone has enhanced economic integration among member countries, facilitated labor movement, fostered economic development, and facilitated members' international trade.

The book's value, however, is somewhat diminished by the weakness of the data available for some of its comparisons, particularly in the case of inflation, and by the sample period, which in many instances extends only through 1980. It would have been worthwhile to examine the performance of the franc zone members in the last three to four years, when some of them have been making large and continuous use of Fund resources to cope with their economic problems. Finally, the book does not address current difficulties; it neither offers projections nor analyzes possible developments in the franc zone in view of a persistent weakness of the French franc and the serious external debt positions of some members.

Piero Claudio Ugolini

W. M. Scammell

The International Economy Since 1945

St. Martin's Press, New York, 1984, vii + 244 pp., $27.50.

The second edition of this book covers the years up to 1982. Above all, this book will provide a *convenient, straightforward, historical account* of the major international economic developments since the end of World War II. It should be valuable to the student of international affairs as well as to the economist who requires a general background.

Charles Weiss and Nicholas Jequier

Technology, Finance, and Development

An Analysis of the World Bank as a Technological Institution

D.C. Heath Co., Lexington, MA, USA, 1984, vi + 342 pp., $37.

Financial institutions can have an important influence on technology. In helping to finance economic and social development in the Third World, the World Bank affects the choice and use of technology in a wide variety of ways: it finances and carries out research, advises on and promotes choices of technology, encourages innovation, and helps develop expertise. This book, one of whose editors (Weiss) is Science and Technology Adviser at the World Bank, illustrates the diversity of the Bank's influence on technology. It argues cogently for greater recognition of the power of *financial institutions to promote technological* change.

M. S. El Azhary

The Impact of Oil Revenues on Arab Gulf Development

Westview Press, Boulder, CO, USA, 203 pp, $30.

This *compilation* of 12 symposium papers presented in 1982 is, like many such collections, unfocused. It deals only obliquely and sparingly with its title. Within its relatively brief length (200 pages) and its fairly large geographic coverage (six countries), the individual papers present some familiar outlines of problems and prospects in development planning, infrastructure, agriculture, industry, banking, and manpower training. But the actual impact of reduced (and uncertain) oil revenues on the region's potential development is barely hinted at, and not appropriately examined. Events since 1982, particularly recent weaknesses in the oil market, call for a much more detailed and thorough examination of the subject.

Other books received

Listed below are some of the books we received in 1984 but were unable to review for lack of space.

John Black and Graeme S. Dorrance (editors), **Problems of International Finance,** The Macmillan Press Ltd., London, 1984, xxii + 188 pp., £20.

Deborah M. R. Coyne, **Monetary and Financial Reform: The North-South Controversy,** North-South Institute, Ottawa, 1984, v + 87 pp., Can $6.

B. E. Cracknell (editor), **The Evaluation of Aid Projects and Programmes,** Overseas Development Administration, London, 1984, vii + 149 pp., £5.95.

Michael R. Czinkota and George Tesar (editors), **Export Management: An International Context,** Praeger, New York, 1984, xvii + 291 pp., $27.95.

Thomas O. Enders and Richard P. Mattione, **Latin America—The Crisis of Debt and Growth,** The Brookings Institution, Washington, DC, 1984, viii + 66 pp., $6.95.

Richard E. Feinberg and Valeriana Kallab (editors), **Uncertain Future: Commercial Banks and the Third World,** Overseas Development Council, Washington, DC, 1984, 129 pp., $12.95.

Xabier Gorostiaga, **The Role of the International Financial Centres in Underdeveloped Countries,** St. Martin's Press, New York, 1984, 148 pp., $25.

Pradip K. Ghosh (editor), **Industrialization and Development—A Third World Perspective,** Greenwood Press, Westport, CT, USA, 1984, xxviii + 566 pp, $45.

Herbert G. Grubel, **The International Monetary System,** Penguin Books, New York, 1984, 213 pp., $6.95.

K. L. Gupta, **Finance and Economic Growth in Developing Countries,** Croom Helm Ltd., London, 1984, xiv + 241 pp., £7.95.

Robert L. Heilbroner and Lester C. Thurow, **The Economic Problem,** Prentice-Hall, Englewood Cliffs, NJ, USA, 1984, xxi + 669 pp., $27.95.

Harry D. Hutchinson, **Money, Banking, and the United States Economy,** Prentice-Hall, Englewood Cliffs, NJ, USA, 1984, viii + 535 pp., $28.95.

N. Molenaar, M.S.S. El-Namaki, and M.P. van Dijk, **Small-scale industry promotion in developing countries,** Research-Institute for Management Science, Delft, The Netherlands, 1984, 217 pp.

Ehsan Nikbakht, **Foreign Loans and Economic Performance—The Experience of the Less Developed Countries,** Praeger, New York, 1984, xviii + 134 pp., $29.95.

Payment by Results, International Labor Office, Washington, DC, 1984, xii + 164 pp., $14.25.

Rita M. Rodriquez and E. Eugene Carter, **International Financial Management,** Prentice-Hall, Englewood Cliffs, NJ, USA, xi + 629 pp., $27.95.

A. E. Safarian, **Governments and Multinationals: Policies in the Developed Countries,** British North American Committee, Washington, DC, 1983, ix + 117 pp., $8.

William James Stover, **Information Technology in the Third World,** Westview Press, Boulder, CO., USA, 183 pp., $15.

Michael L. Wachter and Susan M. Wachter, (editors) **Removing Obstacles to Economic Growth,** University of Pennsylvania Press, Philadelphia, 1984, xiii + 493 pp., $29.95.

L. de V. Wragg (editor), **Composite Currencies: SDRs, ECUs and other instruments,** Euromoney, London, vi + 162 pp., $85.

IAN BOWEN
1908–84

We regret to note the death of our former Editor, Ian Bowen, in London on November 20, 1984. Born in Cardiff, he was educated at Oxford, where he became a Fellow of All Souls College. After teaching at Brasenose College, he worked for the U.K. Government during World War II, returning to academia in 1946. He taught at Hertford College and then was Professor of Economics and Commerce at Hull University and Professor of Economics at the University of Western Australia before joining the World Bank in 1972. He became Editor of *Finance & Development* in 1974, succeeding the founding Editor, John Scott. The author of a number of books, most recently *Economics and Demography* (1976), he lived in Andorra after retiring from the journal in 1977.

Letters

Mobilizing domestic resources

In the September 1984 issue the Bank's Senior Vice President, M. A. Qureshi, answered *Finance & Development*'s various questions on mobilizing finance for development; the ratio of shares ($3 billion) to generated commitments (about $95 billion) is more than impressive. But organic development is more in need of mobilizing indigenous human and financial resources than of pure resource transfers, which often lead to increased bureaucracies, financial dependencies, and weakened efforts to mobilize financial means within the country. Many projects, especially in the field of rural development, need little or no foreign exchange. It is therefore refreshing to hear that "really only a little bit more money" is needed. With innovative guarantees and adequate technical assistance, the Bank could, I believe, raise even more money for development within the recipient countries, while also creating increased responsibility for its proper utilization. This would complement the Bank's services and should be included in the exercise to determine the future role of the Bank, because this area was certainly neglected in the past.

Heinrich Bechtel
Lindenfels, Germany

Mr. Qureshi replies:

I agree that a successful development effort must be based primarily on the mobilization of a country's own human and financial resources. Foreign assistance should not be—and generally has not been—a substitute for domestic efforts. Over the last 25 years over 90 percent of investment in developing countries has indeed been financed by domestic savings. World Bank financial resources have provided a very small share of total investment in developing countries. The key is to use external financial support as a catalyst to encourage and support domestic efforts. The Bank's recently proposed Joint Program of Action for Sub-Saharan Africa is a good example of how this can and should be done.

A Fund-Bank merger?

What the vital "exchange" (September 1984) between Killick and *Finance & Development*'s Editor indicates is the complexity of the issue and the problem of an ideological commitment to policy prescriptions. For example, Nowzad states that some IMF-supported policies are "distinctly supply-side oriented," and asserts that adjustment must be part of "an integrated policy package" that includes demand management. Killick questions the efficacy of the demand restraint approach and advocates "a cost-minimizing, growth-oriented framework."

I guess both are basically supply-siders! However, the policy recommendations for adjustment in developing countries are generally market-oriented, while there is the reality of a dominant public sector.

The exchange reveals the necessity for continuing examination of the institutional evolution and role of both the Fund and the Bank, given the changing patterns of trade, payments, and development. Although there is apparent cooperation between these Bretton Woods institutions, even if it is not always orderly and effective, one gets the impression that serious consideration should be given to consolidating these institutions into the International Agency for Finance and Development.

Bernard P. Appia
Fordham University

Population growth

I read with special interest the article by Nancy Birdsall, "Population growth—its magnitude and implications for development" (September 1984).

I recognize her great competence with respect to demographic matters in the developing world but, with her permission, I would like to make a few points that, to my great surprise, were overlooked.

Her analysis of fertility problems has touched almost exclusively on material aspects. In my opinion, however, other more influential factors are involved in increased fertility, particularly inheritance patterns, the role of farm children as workers, the recommendations of the different religions that promote increased fertility, human pride in the number of children, a degree of reluctance in all countries to address sexual problems, and, finally, the physical and biological potential for reproduction in the Third World, which is not found in the developed countries.

Ben Jelloun Jaouad
Casablanca, Morocco

Nancy Birdsall responds:

Mr. Ben Jelloun is, of course, correct that children provide emotional satisfaction. Many noneconomic factors influence fertility and religious and cultural factors also play a role. At the same time, too, the economic gain (or a small economic loss) that children represent for a poor family may preclude any interest in having few children. In this sense, at least, economic factors matter.

My article was based on the Bank's World Development Report 1984. *An important message of the* Report *is that religious and other factors do not rule out effective public action to assist people to have the number of children they want. In every part of the developing world, including Catholic Latin America and Islamic Middle East, some governments have made significant progress in developing such programs. I hope readers will have the opportunity to read the* World Development Report *itself.*

A "model" article

I wish to compliment you on publishing "The effects of adjustment" by Wanda Tseng in your December 1984 issue. It presents, within a few pages, the essentials of the problem in a form that is easily understood by the nonspecialist in the field of economics and, indeed, would be useful as well to the educated layman. Its avoidance of technical jargon and difficult mathematics is a triumph of comprehension over academic pretension. It should be a model for our textbook writers. I will use the article in my classes. I recommend more articles of this kind.

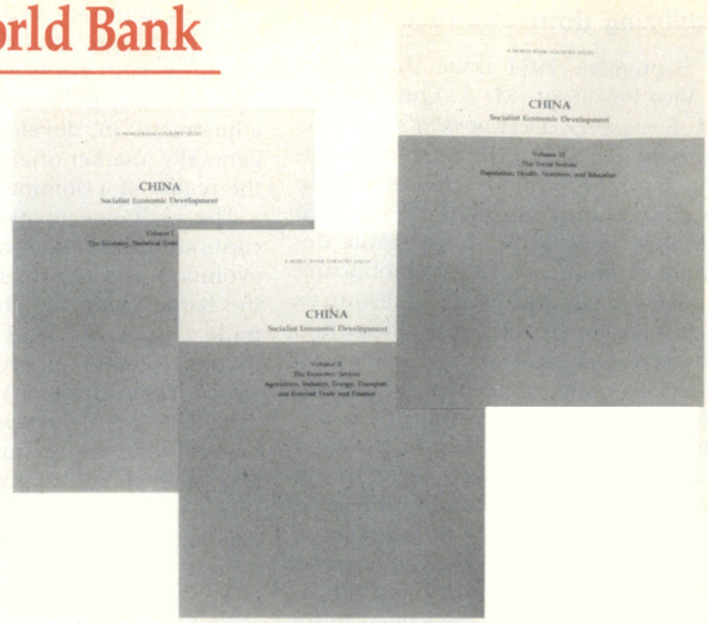
Herman I. Liebling
Bethesda, MD, USA

Update

In the article "Agricultural lending by the Bank, 1974–84" by Montague Yudelman in our December 1984 issue, the figures shown in the table on page 45 for World Bank and IDA commitments for agriculture and rural development by regions for fiscal year 1984 were provisional estimates. Final figures for several regions are different. These are East Africa—$166.8 million; EMENA—$474.1 million; East Asia—$504.4 million; and South Asia—$967.2 million. The updated total is $3,472.9.

Publications from The World Bank

China: Socialist Economic Development



Three-volume set analyzes economic progress since 1949. Covers past development, current policy, and future options. Identifies problem areas. Annexes on the statistical system, population, health, nutrition, and education.

Also Available . . .

Rural Development in China
Dwight H. Perkins and Shahid Yusuf
Focuses on agricultural performance. Outlines successes and failures of current policy.

The Johns Hopkins University Press/The World Bank

China
The Health Sector
Dean T. Jamison and others
Reviews China's achievements to date in improving health and in reducing fertility and malnutrition.

From the World Bank's Staff Working Paper Series . . .

Agricultural Prices in China (WP 606)
Decentralized Renewable Energy Development in China: The State of the Art (WP 535)
Economic Evaluation of Investment Projects: Possibilities and Problems of Applying Western Methods in China (WP 631)
Economic Reform in Socialist Countries: The Experiences of China, Hungary, Romania, and Yugoslavia (WP 579)
Irrigation Management in China: A Review of the Literature (WP 545)
Recent Chinese Economic Reforms: Studies of Two Industrial Enterprises (WP 652)
Trends in Food and Nutrient Availability in China, 1950-81 (WP 607)
Worker-Peasant Education in the People's Republic of China (WP 527)

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