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

International capital flows and economic development

A review of the experience and lessons for the future

Francis X. Colaço

The economic turbulence of the past few years has subsided. The recovery of industrial economies in 1983–84, policy adjustments by many developing countries, and flexibility by commercial banks in dealing with debt-servicing difficulties have all helped to calm the atmosphere of crisis. Economic growth has also recently resumed in many developing countries. This does not mean, however, that the world economy has regained its momentum of the 1960s or that development is again proceeding rapidly. Growth has slowed in most developing countries that experienced debt-servicing difficulties and even in many of those that did not. Average per capita incomes are no higher in real terms in most of Africa than they were in 1970, and in much of Latin America than they were in the mid-1970s. Dozens of countries have lost a decade or more of development.

The experience of the past few years has raised many questions about the role of international capital in economic development—the theme of the World Bank's *World Development Report 1985*. It is important not to lose sight of the fundamentals of international capital. Capital has traditionally flowed from richer countries to those at earlier stages of development, where the expected rates of return tend to be higher. Questions about the nature of capital flows, their terms, and their uses were relevant in the 19th century and remain so today.

The 1985 *Report* offers a broad and long-term perspective on the role of international capital in economic development. It emphasizes that international flows of capital can promote global economic efficiency and can allow countries with balance of payments deficits to strike the right balance between reducing their deficits and financing them. However, the availability of international capital also involves risks: first, it may allow countries to delay the policy reforms required for adjustment; and second, countries may borrow too much, if they misjudge the way external economic conditions are going to evolve.

There is considerable evidence that capital flows, often accompanied by technical know-how, have played a part in the progress made by developing countries over the past 20 years. Foreign capital has also helped individual countries to cushion shocks—either internal ones, such as harvest failures, or external ones, such as large fluctuations in commodity prices or recessions in industrial economies. Countries that accompanied borrowing in the difficult 1970s with policy reforms restored rapid growth and avoided debt-servicing difficulties. Others used borrowing to avoid adjustment and many of these ran into debt-servicing problems requiring even more drastic and costly adjustment later.

The World Development Report 1985 was prepared by a team led by Francis X. Colaço and comprising Alexander Fleming, James Hanson, Chandra Hardy, Keith Jay, John Johnson, Andrew Steer, Sweder van Wijnbergen, and K. Tanju Yürükoglu. The Economic Analysis and Projections Department, under the direction of Jean Baneth, supplied data for the *Report*. Enzo Grilli and Peter Miovic coordinated the work on projections. The work was carried out under the general direction of Anne O. Krueger and Costas Michalopoulos.

The World Development Report 1985 *is published in English, Arabic, Chinese, French, German, Japanese, Portuguese, and Spanish.* *See page 18 for ordering details.*

The historical context

The 1970s and early 1980s saw a substantial increase in capital flows to developing countries, and, compared with the 1960s, a decrease in the relative importance of concessional and nonconcessional official flows. As a result, both the gross and net debt of developing countries increased sharply. Between 1970 and 1984 the outstanding medium- and long-term debt of developing countries expanded almost tenfold, to $686 billion, despite a decline in capital flows since 1981 (see chart). The most striking feature of this growth was the surge in lending by commercial banks, whose share of total new flows to developing countries increased from 15 percent in 1970 to 36 percent in 1983.

The debt-servicing indicators of developing countries deteriorated, as their debt increased and real interest rates rose and export growth rates slowed, particularly after 1979. The ratio of debt to GNP more than

doubled from 14 percent in 1970 to almost 34 percent in 1984. The ratio of debt service to exports rose from 14.7 percent in 1970 to a peak of 20.5 percent in 1982, declining to 19.7 percent in 1984. Interest payments on debt increased from 0.5 percent of GNP in 1970 to 2.8 percent of GNP in 1984 and accounted for more than half of all debt-service payments in that year. These averages conceal wide regional and country differences.

Dramatic though the recent growth of foreign borrowing has been, it is not unprecedented. The volume of external capital flows has often been larger as a proportion of GDP of investing countries or of domestic investment in recipient countries during earlier periods than it was in the 1970s. Debt-servicing difficulties were quite common in the late 19th and early 20th centuries and usually were caused by a combination of poor domestic policies and a deteriorating world environment. Debt repudiations and defaults, however, were not confined to developing countries; some borrowers in the United States, for example, defaulted on their external debts in the 50 years prior to World War I.

By historical standards, debt-servicing difficulties in the 1960s and 1970s do not seem unduly serious. In the 1970s, for example, despite the sharp fall in their terms of trade in 1973–74, an average of three developing countries a year rescheduled their debts. It is only in the 1980s that debt problems have multiplied. The number of reschedulings rose to 13 in 1981 and to 31 (involving 21 countries) in 1983 and a similar number in 1984.

In recent years, developing countries have become more vulnerable to debt-servicing difficulties for three related reasons. First, the volume of loans has increased to a level much above that of equity finance, resulting in an imbalance between debt and equity. Second, the proportion of debt at floating interest rates has risen dramatically, so borrowers are hit directly when interest rates rise. Third, maturities have shortened considerably, in large part because of the declining share of official flows.

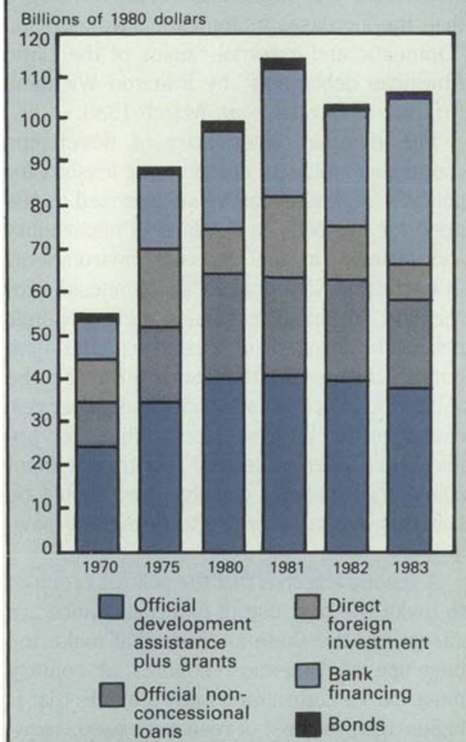
Another major and disturbing difference today is that many of the countries with debt-servicing difficulties are in the low-income group. Their aid receipts have been erratic mainly because of variations in bilateral ODA. To make up for the lack of adequate ODA flows and direct investment many low-income and lower middle-income countries borrowed on commercial terms and accumulated large amounts of debt in the period after 1970. Low-income countries that, on the contrary, were conservative in their recourse to commercial capital successfully avoided debt-servicing difficulties.

The historical perspective reveals certain broad characteristics about debt-servicing problems. The financial links between industrial and developing countries depend on three related variables: (1) the policies of industrial countries; (2) the policies of developing countries; and (3) the financial mechanisms through which capital flows to developing countries. No analysis of international finance is complete unless it takes account of all these variables.

Industrial country policies

The fiscal, monetary, and trade policies of industrial countries largely determine the external climate for developing countries. The connection is not simply through growth and protectionism. Increasingly the links are financial through changes in the availability of finance and movements in interest rates and exchange rates. This became clear in 1979–80, for example, when US monetary policy switched from targeting interest rates to targeting monetary aggregates. Interest rates became more volatile. These policies, along with increasing fiscal deficits in industrial countries, contributed to high real interest rates. The result was abrupt increases in debt-service payments. Latin America, with a higher proportion of floating rate debt, was more affected by this change than either East Asia or Africa. Developing countries find it difficult to adjust to sudden and large increases in debt-service payments. In the early 1980s the recession in the industrial countries reduced export volumes and weakened commodity prices for developing countries at a time when real interest rates were rising, making it hard for many countries to service their debts.

Net flows to developing countries, 1970–83



Source: World Bank, *World Development Report 1985.*

The recovery since then in the industrial countries has helped to ease some of the liquidity pressures on developing countries. Real interest rates have softened a little but remain at historically high levels. World trade expanded rapidly. However, the world recovery in 1983–84 did not lead to the normal cyclical rise in commodity prices in dollar terms. This was in part due to the US dollar's further appreciation, as well as to technological and other factors affecting the demand for commodities. Thus net primary commodity exporters (such as Brazil) benefited less than countries that are net commodity importers (such as Korea). In addition, all developing countries continue to be affected by protectionist measures in the industrial economies.

For the future, the effects that industrial countries have on developing countries will depend primarily on what happens in two areas of policy: real interest rates and protectionism. Large budget deficits in industrial countries remain an obstacle to lower interest rates. Credible measures are needed in those countries to reduce public sector reliance on domestic and foreign savings; this could lower interest rates and foster growth. The United States has recently announced steps that, when implemented, would permit significant reduction in its fiscal deficits in the next few years. Avoiding the recessionary impact of such a policy change will require careful coordination of monetary and fiscal policies among the major industrial countries.

The second issue of vital concern to developing countries is protectionism. To service their foreign debts, the largest debtors will need to run sizable trade surpluses in the next few years. Yet many import restrictions—on steel, sugar, and beef, for example—have affected primarily major debtors including Argentina, Brazil, Korea, and Mexico. Other protectionist measures, such as the Multifibre Arrangement, affect a broader range of countries.

When developing countries cannot earn the foreign exchange to expand their imports, exporters in the industrial countries suffer. For example, US exports of manufactures to major debtors fell by 40 percent between 1980–81 and 1983–84. Such harm is widespread, since industrial economies run a surplus on trade in manufactured goods with developing countries. Protectionism, by curtailing import growth of developing econom-

ies, slows the adjustment and growth that the industrial countries themselves so badly need.

Over the long term, protectionist barriers in the industrial world can have a profound effect on development strategy. They suggest to governments in developing countries that a strategy based on export growth is highly risky, and may thus encourage a return to the inward-looking policies of earlier years. There is abundant evidence that inward-looking policies are bad for growth and employment in the developing countries and also reduce the scope for industrial countries to promote improvements in productivity in their own economies.

Developing country policies

The past dozen years have underlined the crucial role of domestic policies in determining the performance of developing countries, particularly in the use of foreign finance to promote growth through higher investment and technology transfers. In the 1970s it was right for countries to borrow when real interest rates were low or negative—but only if they followed appropriate policies in three principal areas—key economic prices, exchange rate and trade policies, and domestic savings—and invested in economically justified projects. It was wrong to assume that low interest rates would continue, and that it is always expensive to reverse investment decisions. Such mistakes were quickly exposed when world conditions deteriorated in the early 1980s.

Developing countries suffered in 1979–84 from a combination of more expensive oil, historically high real interest rates, prolonged recession in industrial economies, and more trade barriers. Despite this, as many as 100 countries continued to service their foreign debt without interruption. Some experienced only small external shocks, including countries that were oil exporters or those that benefited from workers' remittances (for example, certain Asian and Middle Eastern countries); many of these countries are now having to deal with the effects of lower oil prices and reduced workers' remittances. Some had borrowed only a little or mainly on concessional terms in the 1970s (for example, China, Colombia, and India). Other borrowers undertook economic policy reforms that facilitated debt servicing (for example, Indonesia and Korea).

Countries that ran into debt-servicing difficulties, however, were not necessarily those that had suffered the biggest shocks. They were countries that had borrowed and failed to adjust or had not tackled the new problems with sufficient urgency. Among these were the low-income countries of Africa, whose development is a long-term process constrained by weak institutional structures, a shortage of skills, and often (as in the past ten years) natural disasters as well. These countries had traditionally used concessional capital; in the 1970s many of them borrowed on commercial terms both for consumption and for investment in large public projects, many of which contributed little to economic growth and to debt servicing.

Another group of countries with debt difficulties includes many countries in Latin America and some major debtors. The reasons for their financing problems are more complex, but three common features are: (1) fiscal and monetary policies that were too expansionary to achieve a sustainable external balance; (2) overvalued exchange rates that prevented exports from competing on world markets and encouraged capital flight; and (3) investment increases that were even larger than the increases in domestic savings. (See "Domestic and external causes of the Latin American debt crisis" by Eduardo Wiesner, *Finance & Development*, March 1985.)

The diverse experiences of developing countries emphasize certain basic lessons for policy. One lesson can be summarized as the need for flexibility in the face of uncertainty and changes in the external environment. Countries as varied as India, Indonesia, Korea, and Turkey have adapted their economic policies to changed circumstances. The most critical changes in the short term are the ability to reduce fiscal deficits and adjust real exchange and interest rates. When, for political or other reasons, countries cannot adjust their policies quickly, they should be conservative in resorting to foreign borrowing.

A second lesson is that the policies required to make the best use of external finance are essentially the same as those that make the best use of domestic resources. A country must earn a return on its investments that is higher than the cost of resources used. However, in the case of foreign finance, a country also has to generate enough foreign exchange to cover interest payments, plus remittances of dividends and profits. This depends on actions in three areas:

- Key economic prices must be aligned with opportunity costs. This encourages activities in which the country has a comparative advantage and increases the flexibility of productive structures. Subsidies, when used, should be carefully targeted, for example to the poorest segments of society. Further, investment decisions are influenced by the appropriateness of pricing structures, including interest rates. Governments need to evaluate carefully their own investment programs and to create a framework of incentives to ensure that private investors allocate resources in the most efficient way.
- Exchange rates and trade policies also play a major role. In the 1970s and early 1980s many countries allowed their exchange rates to become overvalued and implemented inappropriate trade policies. This biased production toward the domestic market, stimulated imports, and provoked capital flight. Protectionist trade policies adversely affect the efficiency of utilization of resources and expansion of trade.
- Efforts to raise domestic savings should be strengthened in both the public and the private sectors, despite the availability of external capital. The correct role of foreign finance is to supplement domestic savings; it must not substitute for them. The danger of poor savings performance was well understood by many governments as evidenced by the fact that, in the 1970s, two thirds of a sample of 44 developing countries increased their domestic savings in relation to GNP.

Managing foreign flows

Policies determining the level of domestic savings and investment also determine the need for foreign borrowing, so the management of capital flows should be an integral part of macroeconomic management. Certain aspects of debt management deserve special attention.

The first issue is whether and how governments should regulate foreign borrowing and lending by the private and public enterprise sectors. The answer depends fundamentally on a government's macroeconomic and incentive policies; in general, less government intervention is needed when prices, interest rates, and exchange rates reflect opportunity costs. Although some governments have constructed elaborate controls over capital inflows and outflows, experience strongly suggests that these are no substitute for sound macroeconomic policies. Nonetheless, some procedures for regulating capital movements—prior approval for borrowing, minimum maturity or deposit requirements, or withholding taxes—have sometimes usefully complemented fiscal, monetary, and trade policies.

The second broad area of concern is the composition of capital flows and debt. This involves decisions about: (1) the terms of foreign borrowing—interest, maturity, and cash flow profiles; (2) the currencies in which liabilities are denominated; (3) the balance between fixed rate and floating rate instruments; (4) ways of sharing risk between lenders and borrowers (including the balance between debt and equity); and (5) the level and composition of a country's reserves. It is not possible to formulate precise rules for external debt management that will apply to all countries. The experience of the past few

Table 1
Current account balance and its financing in developing countries, 1984 and 1990
(In billions of 1980 dollars)

	1984[1]	High 1990	Low 1990
Net exports of goods and nonfactor services	14.5	−38.6	6.3
Interest on medium- and long-term debt	−59.3	−44.9	−76.3
Official	−10.8	−12.8	−18.4
Private	−48.5	−32.1	−57.9
Current account balance[2]	−36.4	−60.7	−48.6
Net official transfers	12.2	15.2	14.5
Medium- and long-term loans[3]	51.3	55.1	36.6
Official	26.2	20.4	20.2
Private	25.1	34.7	16.4
Debt outstanding and disbursed	702.5	716.2	741.4
As percentage of GNP	33.8	24.7	27.8
As percentage of exports	135.4	98.2	133.1
Debt service as percentage of exports	19.7	16.0	28.0

Source: World Bank data.
Note: The table is based on a sample of 90 developing countries. The GNP deflator for industrial countries was used to deflate all items. Details may not add to totals because of rounding. Net exports plus interest does not equal the current account balance because of the omission of net workers' remittances, private transfers, and investment income. The current account balance not financed by official transfers and loans is covered by direct foreign investment, other capital (including short-term credit and errors and omissions), and changes in reserves. Ratios are calculated using current price data.
[1] Estimated.
[2] Excludes official transfers.
[3] Net disbursements.

years, however, argues for prudence by developing countries in deciding on both the volume of foreign borrowing and its composition, and in maintaining enough reserves to give a country time to adjust to domestic or international pressures without unduly jeopardizing economic growth.

Many countries fail to manage capital flows effectively because of inadequate data, a lack of technical expertise about financing options, and an absence of institutional arrangements to integrate debt management with macroeconomic decision making. In all these areas, institutional development is an important priority.

Financial mechanisms

Developing countries account for only a small proportion of international flows of capital, so their influence on the international financial system is limited. The system itself evolves in response to three main factors. First is the external environment. For example, changes in regulations, financial innovations, and high and volatile inflation in the 1970s led investors to lend at floating rather than fixed rates. Second, the demand for the services of financial markets and institutions is affected importantly by global payments imbalances. For example, OPEC countries in the 1970s and early 1980s initially preferred to keep their surpluses in highly liquid form, so commercial bank deposits and lending increased. More recently, the large current account deficits run by the United States, which have their counterpart in surpluses in Japan and other industrial countries, have led to a much larger role for international asset markets. Third is the preferences of financial institutions. For example, in the 1970s commercial banks chose to lend abroad to satisfy their own portfolio and profitability objectives.

Table 2
Net financing flows to developing countries, and projections
(In billions of 1980 dollars)

Type of flow	1984	1990 High	1990 Low	Growth rate[1] (Percent) 1970–80	1985–90 High	1985–90 Low
Official development assistance[2]	21.8	25.1	24.2	6.1	2.7	2.0
Nonconcessional loans	41.8	45.2	26.9	12.3	4.4	−5.9
Official	16.6	10.5	10.5	13.9	2.3	2.3
Private	25.1	34.7	16.4	11.9	5.1	−9.5
Direct investment	9.6	12.3	11.8	5.8	4.2	3.2
Total[3]	**73.2**	**82.6**	**62.9**	**9.1**	**3.8**	**−1.7**

Source: World Bank data.
[1] Average annual percentage change.
[2] Includes ODA grants (official transfers). DAC reporting includes, and the World Bank Debtor Reporting System excludes, ODA flows from nonmarket economies and the technical assistance component of grants. There are also differences in coverage of recipient countries in the two data sources.
[3] Excludes short-term capital and reserve changes.

In the short term, developing countries have to make the most of the opportunities presented by the international financial system. For the long term, the key policy questions are: How can the stability of external capital flows be enhanced and lending by banks be restored? And what arrangements can be made for the future financing of external deficits, including enough concessional assistance, to meet the needs of low income countries?

The answers lie in five areas:

- ***Longer maturities.*** Developing countries can borrow for the long term, though seldom directly from the market; they will continue to rely almost exclusively on the intermediation of the World Bank and regional development banks for the next few years. Financial innovation to expand the range of maturities available to developing countries would help them to manage their debt and reduce refinancing risks.
- ***Hedging.*** The financing instruments used in the 1970s meant that developing countries assumed the risks of adverse developments in the world economy. There was no effective risk sharing. Instruments for hedging risks exist in many financial markets and should be used to a greater extent in lending to developing countries.
- ***Commercial risk sharing.*** Conventional bank loans do not involve sharing commercial risks; foreign direct and portfolio investment does. The introduction of equity-based instruments in lending to developing countries is another area where progress could be made since they involve sharing of commercial risk.
- ***Secondary markets.*** As most commercial lending to developing countries in the 1970s was by banks, it tended to increase risks by concentrating assets in a single group of creditors. The phased expansion of secondary markets for some types of developing countries' liabilities could widen the range of lenders, diversify the risks, and enhance the stability of lending.
- ***Aid volume and effectiveness.*** Low-income countries need considerably more development aid than is available at present. They also need to use aid efficiently. Donors can improve their own efficiency by focusing their aid primarily on development objectives

and by coordinating their efforts within programs agreed with the recipient.

Prospects and options

How much and what kind of foreign finance will developing countries need in the years ahead? That question can be answered only by analyzing the global outlook for growth, trade, interest rates, and so on. Traditionally, the Bank's annual *World Development Report* presents alternative scenarios for ten years ahead. These, it needs emphasizing, are not predictions; their outcome depends on the policies adopted in industrial and developing countries. Nor do they allow for exogenous shocks to the world economy. Last year's *Report* contained scenarios to 1995. The discussion in this year's *Report* is in the context of last year's scenarios, but pays greater attention to the next five years.

The next five years will be a period of transition. During that time, about two thirds of the debt of the developing countries will need to be repaid or rolled over. The constructive and collaborative actions, including multiyear debt restructurings, taken by debtors, creditors, and international agencies in recent years need to be continued. Their objective is to accelerate the return to creditworthiness of countries that are pursuing sound economic policies, but have sizable short- to medium-term debt-servicing requirements. These actions need in particular to be extended to countries—several middle-income exporters of primary commodities and many low-income African countries—where debt-servicing difficulties and development problems are intertwined. Consideration needs to be given to the extent to which multiyear debt restructuring for official credits and other arrangements might be feasible on a case-by-case basis, as part of overall financing packages supporting stabilization and adjustment, particularly in low-income sub-Saharan African countries committed to strong adjustment efforts.

Over the past few years, many developing countries have made progress in dealing with their financial difficulties. The economic situation, however, remains fragile in many countries. GDP growth in 1980–85 is currently estimated at slightly more than one half that of 1973–80. Exports in 1980–85 have grown at close to 6 percent a year, but the pressure of continued high interest payments has kept import growth at only a little more than 1 percent a year. Substantial trade surpluses run by many developing countries have been used to meet greatly increased interest payments. The high level of real interest rates is thus one of the critical variables whose course will influence outcomes in the next five years. Developing countries need to keep the rate of growth of export earnings above the rate of interest, even if the current account (net of interest payments) remains in balance, if the major debt ratios are to return to more sustainable levels. This will depend not only on their own policies but also on the rate of growth of industrial economies and whether or not protectionist measures are rolled back.

Two simulations—a Low and a High—have been prepared by Bank staff for the period 1985–90. Both assume that developing countries continue with their present course of policies, which in many cases (as, for example, in some low-income Asian economies) imply substantial policy reforms and adjustment efforts. Policy improvements in three principal areas—key economic prices, exchange rates and trade policies, and domestic savings. These contribute to efficiency in the use of resources and to export competitiveness. As for industrial economies, the difference between the simulations is that the Low case assumes a set of policies that fail to address current problems and as a result lead to further problems, while the High one embodies policy changes that result in greater progress in adjustment.

The Low simulation assumes: no progress in reducing budgetary deficits and in improving the monetary-fiscal balance so that real interest rates remain high; a failure to tackle labor market rigidities so that unemployment stays high and real labor costs continue to increase; and a substantial increase in protection. The High simulation, by contrast, assumes progress on all these fronts—lower interest rates, lower unemployment, and a reduction in protection.

For developing countries, in the High simulation output grows at a healthy 5.5 percent a year (or 3.7 percent a year per capita), and there is a major improvement in all the major debt indicators. The Low simulation produces a more problematic outcome: growth slows to 4.1 percent a year (or 2.3 percent a year per capita). But, if there is a sizable reduction in economic growth, the impact on debt servicing is even more striking. A combination of high real interest rates and protection makes debt servicing considerably more difficult. The main debt indicators deteriorate; for a large number of countries debt-service ratios reach high levels. The volume of concessional aid declines as a result of slower growth in industrial economies, and "involuntary" lending, in the face of deteriorating creditworthiness, continues to be required.

The two simulations outline a continuing bleak outlook for many low-income African countries. In the High simulation, their average per capita income stagnates at present reduced levels; in the low simulation, there is yet another period of falling per capita incomes. Special efforts are therefore needed to deal with those prospects. These must be based on major changes in African programs and policies and supported with additional external assistance, over and above that projected in the High simulation.

The challenge for the next five years is to ensure that the world reaches the High case. It is quite clear that foreign capital will play a significant part in meeting the challenge of faster growth. Actions by creditors, debtors, and the international community would contribute under these circumstances to international capital resuming its productive role in economic development.

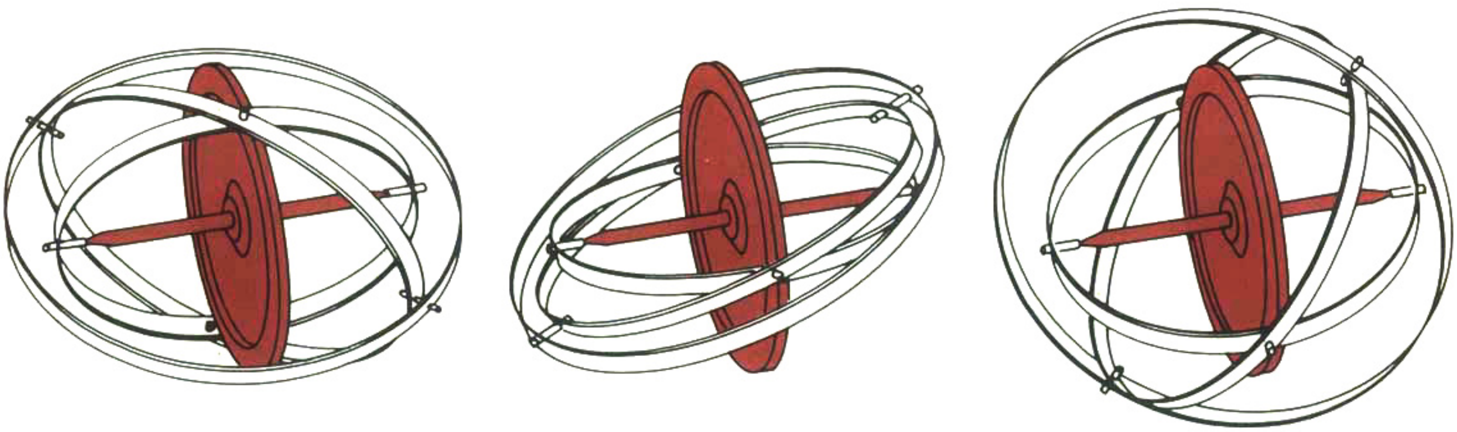
Role of the Bank

In contributing to the resumption of growth and the restoration of creditworthiness of the developing countries, the World Bank is addressing investment and institutional development issues crucial to sustaining longer-term progress. Against the background of growing strength in domestic institutions in borrowing countries and much greater resource scarcity than in the 1960s and 1970s, Bank assistance is helping governments to strike an appropriate balance between additional investments and the maintenance of existing capacities, to achieve greater selectivity and efficiency in public sector investments, and to develop a framework of policy and institutional arrangements conducive to the growth of activities in the private sector.

The financial resources provided directly by the Bank make important contributions to restored growth and momentum to development, but they can never be more than a rather small proportion of the total resources required. The Bank is, therefore, strengthening its catalytic functions, particularly with respect to aid coordination in sub-Saharan Africa, cofinancing with commercial banks and export credit agencies, and the promotion of private investment. In addition to its direct lending, the tasks of complementing and—to the extent possible—exercising a constructive influence on capital flows from other sources are also important factors in shaping the future role of the Bank.

Michele Iannacci for F&D

Francis X. Colaço *from India, received his PhD from the University of California at Berkeley, and taught at Brown University before joining the Bank in 1969. Most recently, he was Staff Director,* World Development Report 1985.



The IMF: 40 years of challenge and change

How, through innovation and adaptation, the Fund has attained its present character

Margaret Garritsen de Vries

December 27, 1985 marks the fortieth anniversary of the signing of the Fund's Articles of Agreement by the 39 original members, a ceremony that gave birth to the International Monetary Fund. In 1945, no one knew how well the new organization would work. The new members themselves held profoundly conflicting views as to how vital and effective the Fund *should* be, some arguing that the need for little activity would indicate the Fund's success. Today, while some would have the Fund perform otherwise than it currently does, the Fund is nonetheless regarded as one of the more influential and effective international organizations.

The Fund's membership has grown to 148, encompassing virtually all countries except a few, principally in the Eastern Bloc. In recent years, the People's Republic of China has taken up the representation of China, and two East European countries—Hungary and Romania—have become members. Financial resources from members' quota subscriptions have grown nearly twelvefold, to just under SDR 90 billion, and the Fund has been able to supplement these resources considerably by temporary borrowing from the governments and central banks of several of its members. Today the Fund is widely recognized to have played a key role in containing a world financial crisis that might otherwise have resulted from the severe debt-servicing difficulties that arose in mid-1982. It is the major forum in which financial officials consider and help resolve international monetary problems.

The Fund's evolution into an effective international organization is largely attributable to its ability to adapt its activities, policies, policy-making bodies, procedures, and even its Articles in response to changing circumstances. The Fund has shown a capacity to adapt not foreseen by its founders.

A slow start

When the Fund opened its doors in March 1946, it was eager to start enforcing the code of conduct with which it had been entrusted, including agreed par values for exchange rates, the abolition of exchange restrictions, and the establishment of currency convertibility. However, the Fund soon found that it faced serious problems in doing so.

First, the postwar economic problems of reconstruction and the major readjustments that most members needed to make in their economies and trading relations proved much more difficult than had been expected. For over a decade most members could not fully assume their Fund obligations, finding it especially difficult to eliminate restrictions and establish currency convertibility. Second, as an untried international organization, the Fund had difficulty in asserting its authority. Third, the Fund was hampered by its inability to disburse money. While most members needed US dollars urgently, the Executive Board was sharply divided between those who believed that members had an automatic right to draw on the Fund's resources and those who believed that access to its dollar holdings should be subject to fairly strict conditions.

Moreover, it was decided that the Fund should not give financial assistance to recipients of Marshall Plan aid. In any event, financial authorities regarded lending as a subsidiary function of the Fund, and the Fund's resources as intended for short-term use only.

In these circumstances, the Executive Board took many decisions that in effect tied the Fund's hands. Much to the frustration of the first Managing Director, Camille Gutt, the Fund made few transactions, was involved only formally in members' exchange rate decisions, had relatively few discussions with members of their economic policies, and took little action against the extensive exchange restrictions of European members. Instead, the Fund concentrated its efforts on multiple rates and discriminatory currency practices, which prevailed mainly in smaller members. This provoked some ill will on the part of developing members, especially in Latin America, which resented the greater attention being paid to their exchange rate practices and restrictions than to those of the major powers.

Far-reaching changes in 1952

By 1952, the Fund's reputation and its relations with many of its members had reached a low ebb. But its officials had learned a lesson: to be of value, the Fund had to meet the most urgent needs of its members. What members needed at that time was help in setting their economic goals and priorities and support in reducing their reliance on restrictions. In that year the Executive Board agreed to two bold undertakings that helped greatly to fill these needs: it ensured that the annual consultations with each member, which were then being inaugurated, would be substantive, and it introduced a general policy on the use of its resources.

The Articles of Agreement required that, beginning five years after the start of operations, the Fund hold annual consultations with each member still maintaining exchange restrictions. When such consultations were begun on March 1, 1952, the climate for them was anything but propitious. Some Executive Directors and even some staff members, deeply wary of the Fund's overstepping its authority, wanted to restrict severely the frequency of consultations, the subject matter to be covered, and any recommendations by the Fund. Others, including Ivar Rooth, the second Managing Director, argued that such limited consultations would compromise the Fund's credibility even further, and spoil the Fund's best opportunity to become a participant in members' economic policy decisions. After much debate, the Executive Board agreed that consultations should be thoroughgoing—that the Fund should review exchange restrictions, the forces necessitating their retention, and ways to eliminate them, including possible financial and technical assistance from the Fund.

At first conducted cautiously and then gradually extended, these annual consultations have enabled the Fund, jointly with the authorities of each member country, to make regular reviews of the full range of its members' balance of payments positions, policies, and prospects. Since the balance of payments is also affected by domestic macroeconomic policies, the Fund necessarily became involved in reviews of these policies, such as fiscal, monetary, and pricing policies.

For more than three decades, annual consultations have been the principal framework for the Fund's Executive Directors, management, and staff to address members' external payments problems. The holding of consultations under Article IV, which deals with exchange rate arrangements, is a key feature of the Second Amendment to the Articles, which became effective in 1978, and the main instrument through which the Fund now carries out its mandate for surveillance over members' economic policies.

The second of the seminal decisions of 1952 gave the Fund a general policy on the use of its resources. Under the "tranche policy" introduced, the Fund's credit was to be available to members in four equal tranches of 25 percent of quota. In addition, members had a "gold" tranche position to the extent that Fund holdings of their currency were less than the quota. Drawings in the "gold" tranche were, in practice, to be automatic (automaticity was formally incorporated in the First Amendment of the Fund's Articles in 1969). Drawings in the credit tranches were to be conditional on a member's economic policies aimed at correcting its balance of payments disequilibrium. The objective was to enable members to lift restrictions, thereby achieving the Fund's basic purposes. Repurchase (i.e., repayment of borrowed currencies to the Fund) was to take place within three to five years. In its suggestion that members might not want to draw immediately but could ensure that they would be able to draw within a subsequent 6 to 12 months' period if needed, the 1952 decision contained the germ of the Fund stand-by arrangement (also not mentioned in the original Articles). By the mid-1960s, stand-by arrangements were virtually the only means by which the Fund provided financial support to its members; in 1974 they became the model for the new extended arrangements; and in 1978 a definition of a stand-by arrangement was included in the amended Articles.

Conditionality, much further developed, today forms the heart of the Fund's financial assistance. Indeed, the unique leverage of the Fund's lending derives from the linking of stand-by arrangements to members' economic policies, reinforced by periodic consultations.

Innovations in the 1960s

By the early 1960s, most of the Fund's initial goals had been achieved: the great majority of its members had established par values for their currencies, the extent and complexity of multiple rates had vastly diminished, and the main European currencies had been made convertible. The Fund had developed a system of international cooperation and consultation on monetary and financial policies that contrasted sharply with the "beggar-my-neighbor" practices of the 1930s. Most important, the industrial countries had achieved unparalleled economic prosperity and developing countries had also made great economic strides.

Nevertheless, the decade of the 1960s presented a new problem. Widespread and growing concern arose about the adequacy of official sources of international liquidity, in general, and the disruptive effects of short-term capital movements, in particular. The two major reserve currency countries, the United States and the United Kingdom, were particularly exposed to frequent transfers of short-term capital, threatening the stability of the international monetary system. To help deal with the problem, the Executive Board, in one of its most significant decisions, ruled in July 1961 that the Fund's resources could be used to help members deal with difficulties arising from short-term capital movements. However, despite the general increase in quotas agreed upon two years earlier, concern continued that, were the United States to draw on the Fund, not enough resources would remain for other members. Hence, in 1962, during the term of the Fund's third Managing Director, Per Jacobsson, the General Arrangements to Borrow (GAB) were created, permitting the Fund to borrow up to $6 billion from the ten largest industrial members, if any of the ten drew. Beyond being an important source of financial resources, the GAB have been a forerunner to additional borrowing arrangements. In the past decade the Fund, benefiting from its experience with the GAB, has entered into new borrowing arrangements with some of its member governments and their central banks as a sizable temporary supplement to its ordinary resources. The GAB themselves have recently been revised (see "Supplementing the Fund's lending capacity," by Michael Ainley, *Finance & Development*, June 1985).

Fears of a shortage of international liquidity persisted, however. The world's production of gold at prevailing prices was wholly inad-

equate as a source of reserves and the United States was planning to eliminate the payments deficits that had been supplying dollars as reserves to the rest of the world. The Fund thus embarked on the five years of negotiations that led to the creation of special drawing rights. This innovation marked the zenith of the Fund's first 25 years and the major achievement of its fourth Managing Director, Pierre-Paul Schweitzer. When the First Amendment, incorporating the SDR into the Articles, became effective in 1969, the Fund acquired the power to supplement international liquidity by creating its own money. It thereby obtained not only a power on which its founders had been unable to agree but also an additional purpose.

Subsequently, the Fund allocated some SDRs; increased the uses of the SDR, especially in its own transactions and operations; and freed the SDR from most of the restraints initially imposed on it. However, the SDR has not become a major asset in the reserve holdings of most countries and certainly not yet the principal reserve asset of the international monetary system, as intended by the Second Amendment.

Another innovation of the 1960s was the introduction of two facilities to help primary producing countries deal with declines in their export earnings stemming from fluctuations in the prices of primary products. The compensatory financing facility to help compensate for temporary shortfalls in export earnings was established in 1963. The buffer stock facility, under which the Fund helps finance members' contributions to approved international buffer stock schemes, was established in 1969. These two facilities were harbingers of later arrangements intended mainly for the benefit of developing members.

Transformation after 1973

Much more difficult challenges arose in 1973 after the par value system, which had been under severe stress since late 1967, finally collapsed when a number of major countries resorted to floating rates. The Fund had never played as important a role in members' exchange rate and par value decisions as had been envisaged at its creation. Some critics nevertheless viewed the end of the par value system and the onset of floating rates as a sign that the Fund had failed, while others argued that the Fund had no further reason to exist. Hence, as of early 1973, the Fund's future character was uncertain.

In that year, historically high rates of inflation and then sudden steep increases in oil prices caused massive imbalances in external payments. In 1974-75, members faced a severe worldwide recession and the hitherto unknown phenomenon of rising prices coexisting with high unemployment in industrial countries. Taking place in the context of floating exchange rates, these developments posed the threat of severe exchange instability and competitive depreciation reminiscent of the 1930s.

Under H. Johannes Witteveen, its fifth Managing Director, the Fund responded quickly. Very soon after the 1972–73 rise in oil prices, it introduced two oil facilities which, in a new departure for the Fund, were financed by borrowings from members. As payments deficits persisted, the Fund continued to seek new arrangements for financing these deficits. The 1970s thus saw the introduction of the extended Fund facility (for adjustment programs of medium-term duration), the supplementary financing facility (to enable the Fund to lend larger multiples of quotas), and a subsidy account to reduce the cost of drawings under the 1975 oil facility by low-income developing members. The Fund also considerably liberalized and extended its compensatory financing facility; expanded the applications of the buffer stock facility; arranged for loans for a number of developing members from a specially created Trust Fund, based on profits from sales of some of the Fund's gold; and disbursed some of its gold holdings directly to members.

These developments in effect transformed the Fund:

- With exchange rates for the main currencies floating, the Fund's regulatory functions received less emphasis than its financial functions;
- Lending became a primary activity;
- The scale of lending, backed by sizable Fund borrowing, no longer depended exclusively on members' subscriptions;
- The Fund became an important financial intermediary, borrowing from some members to lend to others.

Further transformation of the Fund came with the Second Amendment. In brief, floating rates received legal sanction, but the Fund was also given a mandate to "exercise firm surveillance over the exchange rate policies of members." The creation of two new committees of the Board of Governors—the Interim Committee of the Fund's Board of Governors on the International Monetary System and the Joint Ministerial Committee of the Boards of Governors of the Bank and the Fund on the Transfer of Real Resources to Developing Countries—provided high-level policy-making bodies that meet twice a year to discuss and make policy recommendations on major international monetary and development issues.

Since the early 1970s the world economy has been seriously troubled and the Fund has therefore also concerned itself more than before with analyzing world economic problems. Through the "World Economic Outlook" exercise, a series of analytical, empirical, and statistical reports, the Fund now regularly offers an independent international view on the world economy and its prospects.

The Fund history

The new volumes by Margaret Garritsen de Vries are: *The International Monetary Fund, 1972–1978: Cooperation on Trial:* Volumes I and II, *Narrative and Analysis;* and Volume III, *Documents* (Washington, DC, 1985). Earlier volumes were: Margaret Garritsen de Vries, *The International Monetary Fund, 1966–1971: The System Under Stress* (Washington, DC, 1976), two volumes; and J. Keith Horsefield, Margaret G. de Vries, and others, *The International Monetary Fund, 1945–1965: Twenty Years of International Monetary Cooperation* (Washington, DC, 1969), three volumes. These books can be ordered from Publications Unit, Box A-853, International Monetary Fund, Washington, DC 20431, USA.

Responses to the debt problem

In the 1980s, new problems arose as a result of the second round of oil price increases in 1979; the most severe recession since the 1930s in 1981–82; large payments deficits, especially in developing members; critical external indebtedness difficulties in several developing countries; increasing protectionism in industrial countries; and continued swings in floating exchange rates. In response to these problems the Fund, under its sixth Managing Director, J. de Larosière, has taken additional new steps. To meet the needs of developing countries—which have become the predominant users of the Fund's resources—the Fund has introduced longer repayment periods and loans that are larger multiples of quotas. For example, since 1981, under an enlarged access policy, the Fund has provided additional financing in conjunction with its ordinary resources to members facing payments imbalances that are large in relation to their quotas.

The onset of the world debt crisis in August 1982 strengthened the Fund's view that balance of payments adjustment was unavoidable and needed to be pursued vigorously. Working on a country-by-country basis, the Fund has assisted members, especially those with major debt problems, to design and implement adjustment programs that will achieve a viable balance of payments in the medium term. At the same time, it has sought to keep financial flows moving to these countries. In a significant departure from past practice, the Managing Director has helped arrange financial "packages" for a number of debtor members,

on the grounds that a cooperative strategy, involving all the interested parties (debtors, creditors, and the Fund), was necessary for adjustment to be successful and reasonably paced. A signal innovation was that the Fund made its own assistance dependent on the explicit commitment of additional funds by private creditors and other official creditors. As the Fund moves to support medium-term adjustment programs, it has also been strengthening its collaboration with the World Bank.

The Fund is now also strengthening its surveillance over the policies of all members. In particular, in the past two years, consultations with members have placed increased emphasis on the international repercussions of domestic policies.

Change with continuity

As a result of all these changes, the Fund has gradually undergone a metamorphosis. Yet it has held constant the objectives stated in its Articles. First, as a permanent institution for collaboration on international monetary problems, it has consistently sought the complete cooperation of its members and the fullest and frankest consultation possible. Second, it has sought "to facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members. . . ." Third, the Fund has consistently sought to help members attain sustainable balance of payments positions. Finally, it has continuously sought to foster a liberal trade and payments regime.

In sum, by being flexible within the framework of its basic purposes, the Fund has been an effective force in international monetary affairs, despite vastly altered circumstances in the world economy and the international monetary system.

This article has traced the evolution of the Fund over the years in response to changing circumstances, and has outlined its achievements in many areas. This is not to imply, however, that the Fund has not encountered problems, or that its policies and activities have been universally successful. Indeed, even today, the Fund faces a number of important challenges, such as persuading a number of its members to persevere with adjustment programs that are not easy to implement; promoting a pace of adjustment commensurate both with resources available and the implementing capacity of countries; devising stabilization programs for low-income countries, where the problems of development and balance of payments are not easily distinguishable; and exercising a greater degree of influence and surveillance over the economic policies of industrial countries.

These and other problems exist. To meet them in ways acceptable to its membership, and to remain effective, the Fund will have to continue to be imaginative and innovative.

Robert Townsend for F&D

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Recovery, interdependence, and the developing economies

The growth of developed and developing countries is closely linked, but better policy coordination and financial intermediation are needed

Arjun Sengupta

The world economy seems to have now set upon a path of slow recovery. It had suffered a setback in the early 1980s, one that in some sense was the most severe recession since World War II. The volume of world trade, which had been growing at an average rate of 6 percent a year during 1976–1980, actually declined by 0.5 percent in 1981 and by a further 3 percent in 1982. There were also drastic falls in almost all other indices of global economic activity. Developed countries suffered, but the developing countries went through a period of serious crisis, with a sustained and often very significant fall in their per capita incomes. Except for a few countries in Asia, the economic conditions, living standards, and, most important, the rate of capital formation deteriorated sharply for most developing countries—those from the poorer regions of Africa as well as countries from the relatively better off regions of the Middle East and Latin America.

The recovery that started by the end of 1983 gathered some momentum in 1984, the year in which the output of the developed countries grew at about 4.7 percent, their best performance since the mid-1970s. But that growth rate had fallen to about 3 percent by the first quarter of 1985 and the latest OECD projections suggest a growth rate for all OECD countries of around 2.75 percent in 1986. In fact, most projections for the second half of 1980s indicate that developed countries are not expected to grow at an annual rate higher than 3 percent, and that the volume of world trade will grow at best at 5 to 5.5 percent a year. Clearly the recovery, if it is sustained, is going to be slow and halting. Even the most optimistic scenarios do not project a growth rate for developing countries as a whole above an average of 4.5 percent. This is a rate well below what they achieved in the 1960s and the 1970s, and one that for most developing countries will not restore, even by the end of 1990, the consumption levels they enjoyed in 1980.

Fragile recovery

Particularly disconcerting is the fact that the current economic recovery is not only slow and halting but it also seems to be rather fragile. The principal channel of transmission of this recovery, especially to developing countries, is the upswing in the volume of world trade and the expansion of the markets for the exports of developing countries. The projected growth rates of world trade in the next few years fall far short of the average annual growth rate of 7.7 percent achieved in 1967–76, but even that may be threatened by the increasing pressures for protectionism that are noticeable today.

The patterns of growth of developed countries suggested in the different scenarios are not encouraging as regards the problem of unemployment. The rate of unemployment in all industrial countries averaged about 3.5 percent during 1967–76. It increased steadily to 8.2 percent in 1984, and there is little prospect of it declining in the coming years. For Europe, it was 10.7 percent in 1984, and according to the OECD *Economic Outlook*, it is expected to increase to 11.25 percent by the end of 1986. This environment creates fertile ground for the growth of protectionism, to which the democratic governments of the West may be forced to succumb.

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Moreover, the growth of the developed countries, on which depends the growth of exports of developing countries, itself seems uncertain. The estimates of the elasticity (or responsiveness) of non-oil developing countries' exports with respect to the real GNP of industrial countries vary between 1.3 and 2.6, depending on the classification of exports and countries as well as the period of estimation. They all suggest that a fall in the GNP growth of developed countries may produce a significant fall in the exports of developing countries. Furthermore, an OECD study (*International Economic Linkages*) indicates that it may require an OECD growth rate of real GDP of 3 to 4 percent to maintain, in real terms, primary commodity prices relative to the prices of OECD export of manufactures. There is not much prospect for any improvement in capital flows to developing countries, thus the uncertainty about the growth of the industrial countries creates greater uncertainties about the growth of developing countries.

The current recovery in industrial countries seems to be closely related to the growth of the US economy and the large US current account deficits. To the extent the growth of the US economy is not dependent on US fiscal policy and budget deficits but reflects underlying real factors, such as increasing productivity, high rates of return on investment, and successful containment of inflationary expectations, the US recovery may be sustained even if the budget deficit is reduced, and the import surplus and capital inflows are significantly scaled down. However, all the medium-term projections indicate that the large current account deficit will actually expand in the next few years. The latest OECD *Economic Outlook*, for instance, indicates that the current account deficit will grow from $102 billion in 1984 to $151 billion

by the end of 1986. It is this aspect of the near-term scenario of the international economy that makes the prospects of a sustained global recovery very uncertain.

Whatever may be the cause of the increasing current account deficit in the United States—a very large increase in the domestic expenditure compared to other OECD countries or a high dollar caused by large net capital inflows—it reflects a substantial imbalance between the value of imports and exports that is likely to become unsustainable at some point. According to some estimates, a continuation of the present scale of deficits until 1990 would lead to an accumulation of foreign debt by the United States of the order of 150 percent of the value of exports of goods and services, and would require an outflow of resources of 1.5 percent of GNP every year merely to cover interest payments after 1990. Even if, for the sake of argument, one accepts that the capital inflows to the United States are attracted by high rates of real return, and not by high interest rates, there is a limit to foreign indebtedness. After that limit is reached, foreigners may be unwilling to acquire further debt without a sharp rise in interest rates or a fall in the exchange rate. Furthermore, the perception that the market is reaching that limit will grow as the stock of net liabilities to foreigners increases, and this may create an environment of destabilizing expectation and a possible sharp fall, or "hard landing," of the dollar. Whatever else may be the effect of this eventuality, it will almost certainly slow down the process of recovery.

Problems of debtor countries

For the developing countries, there is another highly discouraging element in these scenarios of recovery. The current account deficit of 123 indebted developing countries, which was growing steadily in the 1970s, reflecting a net absorption of resources from abroad, reached a peak of about $113 billion in 1981. Since then it has declined sharply to about $38 billion in 1984 and is expected to fall further to around $37 billion in 1986. This has taken place at a time when outflows on account of interest payments have amounted to around $82 billion a year. For the market borrowers, the current account deficits are projected to fall from $72 billion in 1981 to as low as $5.8 billion in 1986. Interest payments by these countries, which amounted to $57 billion in 1981, would, however, remain at a level of $64 billion in 1986.

Such balance of payments data indicate that from 1983 onward there has been a net resource transfer from the indebted developing countries to developed creditor countries and that transfers will continue in the coming years in the form of surpluses in trade and nonfactor services. According to one estimate, major debtors would have to generate trade surpluses amounting to 4 to 5 percent of their GDP every year well into the 1990s just to meet interest payments on their outstanding debt. A resource outflow of this order of magnitude would be difficult to maintain over a number of years without creating serious economic and social tensions.

Indeed, the problems of the indebted developing countries clearly bring out the essential features of the current international economic situation. There are misalignments, with risks of a possible sharp deterioration of output, consumption, and trade. There is also scope for coordinated international action based on mutually consistent and harmonized national policies. The total debt of developing countries increased from $610 billion in 1980 to $895 billion in 1984. Of this, as much as $472 billion is held by private lenders. Only 16 countries account for 58 percent of the total debt, 8 Latin American countries being responsible for nearly $330 billion. This high concentration of debt suggests the high vulnerability of the system to even minor changes in the conditions of lending, to economic variables affecting the value of debts outstanding, and to the debtors' capacity to service debt.

The concentration of risk as reflected in the over-exposure of the international banks in a few countries has been the principal factor responsible for drying up of commercial bank lending to developing countries. According to the Bank for International Settlements, total net commercial bank lending in the first three quarters of 1984 amounted to only $60 billion—a drastic fall from $165 billion in 1981; of this only $10 billion went to countries outside the BIS reporting area. Most commercial banks had net inflows of funds from these countries that were re-lent to others, mainly developed countries. In the absence of any buoyancy in other sources of capital, either official flows or direct investment, or some kind of international mechanism to spread the risk, share the burden of finances, and more systematic debt rescheduling, the entire burden of sustaining debt and avoiding defaults will fall on the indebted countries. The task of meeting these burdens by debtor countries is made difficult by high interest rates and the overvalued dollar resulting from the uncoordinated macroeconomic policies of the creditor countries. A large part of these debts have been contracted at floating interest rates, and the costs of servicing them have steadily increased in the last few years. The process has been accentuated by the sharp rise in the value of the dollar (since most of these debts are denominated in dollars), while commodity prices have fallen in terms of the dollar.

While it is true that some of the problems of the debtor countries were the result of their own imprudent policies, it cannot be denied that the policies of the commercial banks and the uncoordinated international system of financial intermediation in the years of excess liquidity—the 1970s—were largely responsible for creating the basis for the current debt crisis. The problems have become critical because of the contraction of international credit markets in the early 1980s and the slow economic recovery since then. Whether they can be resolved, or at least contained, in the next few years will, again only partially, depend on the debtor countries' own policies in carrying out adjustment programs. Other important determinants will be international factors such as the extent of the decline in interest rates, the realignment of the dollar and other major international currencies, the continued expansion of world trade, the continuation if not acceleration of the process of recovery, the containment of protectionist tendencies, and the revival of financial flows from commercial banks to debtor countries. These factors, in turn, will depend on developments in the industrial countries, policies adopted by them, how multilaterally coordinated these policies are, and how they affect the functioning of the system of international financial intermediation.

Coordination of policies

In a similar way, whether international recovery can be sustained depends only partially on the policies of individual countries following their narrowly defined national objectives. The more crucial determinants are the international consistency of these national policies, namely whether in the formulation of economic policy each country takes into account the repercussions of its own policies on others. The current recovery does not have to be slow and halting, or fragile and uncertain. In fact, it is possible to formulate internationally coordinated programs that would not only set the course of recovery on an assured path of expansion but also spread the benefits more evenly, with developing countries growing rapidly and the industrial countries maintaining a steady growth rate with price stability.

It is now generally agreed that the most important requirement for sustaining the recovery or preventing a reversal of the process would be a gradual decline in the value of the dollar, without any upward pressure on the US interest rates. It also seems that the entire international community, including the Fund, the OECD, the Group of 10, as well as the US administration believe that the most important policy action in this regard will be a reduction in the US budget deficit. Most simulation models suggest that if the

budget deficits are brought down steadily through fiscal contraction, there will be a reduction in the level of activity and growth rate in the United States in the immediate future. This would exert a downward pressure on the price level and, with no change in money growth, induce a fall in interest rates. The result of lower interest rates would tend to lower the dollar, a development that would be reinforced by the reduction in domestic demand.

The immediate effect of such a scenario would be a downward pressure on the level of activity in other OECD countries through a reduction in their net exports. A large part of the growth of these countries in recent years was generated by export growth, facilitated by the rise in US imports. A reduction in the rate of expansion of the US import market, and increased competitiveness of US exports induced by a lower dollar, would adversely affect the growth of exports and GNP of Western Europe and Japan. To some extent the negative impact on their level of activity could be neutralized by a fall in their interest rate following reductions in US interest rates, with monetary growth and fiscal policy unchanged. But if, to offset the deflationary impact of the US policies, they followed a more active policy of expansion, they could allow interest rates to fall further or expenditure to increase faster, thereby picking up the slack left by the US contraction.

Scenario

Clearly, if a contraction policy in the United States is coordinated with a policy of expansion in the rest of the OECD, the extent of the policy change may be contained within limits. But too sharp a reduction in the current account deficit of the United States may have an excessive impact on the level of activity in other developed countries, unless there are alternative outlets for the excess savings of most of the OECD countries. The recovery of the last few years has been characterized essentially by the absorption by the United States of excess savings of the rest of the OECD, reflected in large current account deficits in the United States accompanied by substantial surpluses in the rest of the OECD countries. If the United States reduces its level of absorption, other OECD countries would either suffer a setback in their recovery or have to follow an expansionary policy, quickly degenerating into inflation. The only way out may be for these excess savings to be invested outside OECD, mainly in developing countries. In a properly integrated international economy, therefore, policy options should not be confined to only one subset of countries.

Most of the simulations of recovery that assume a growth of GNP of the OECD countries at around 3 percent indicate no reduction in the current account deficits of the United States. These deficits remain substantial, even when the current account surplus of the rest of the OECD continues to increase. If the size of these deficits itself becomes a source of destabilizing expectation, as discussed above, by altering the perception about the limits beyond which foreigners would not be willing to hold further stock, of net liabilities, some measures would then have to be adopted to reduce these deficits without precipitating a sharp fall of the dollar or unleashing an inflationary spiral. A sharp fall in the US growth rate would, of course, bring down the deficits, but that would be a colossal waste and the worst example of noncoordination of national policies. If the United States allows a large monetary expansion to offset the effects on GNP growth of tight fiscal policy, interest rates would fall, the dollar would depreciate, current balances would improve, but prices would start rising. There would be a loss of confidence in the anti-inflationary stance of US policy, which would rekindle inflationary expectations in other OECD countries. An expansionary policy in the rest of the OECD is also limited by the fear of stimulating inflation, setting the limits beyond which their surpluses cannot be reduced. So the US deficits can be brought down without upsetting recovery or control over inflation only if the net exports, or the incremental surplus of the OECD countries taken as a whole, find a vent in the non-OECD developing countries.

Financial intermediation

Although the characteristics of the current situation and the source of surplus of the OECD countries are quite different from the situation following the first oil shock of 1973–74 that generated the surplus of the OPEC countries, it is plausible to argue that analytically the world is facing today similar problems of financial intermediation. The current account surplus of the OECD countries other than the United States is expected to increase from $44 billion in 1984 to $77 billion in 1986. It is highly unlikely that marginal changes in domestic policies would affect these surpluses in any significant manner, especially since most countries are firm on their anti-inflationary policies. A reduction in the US deficits would thus increase the net surplus of the OECD countries that cannot be absorbed within the OECD countries, just as the OPEC surplus could not be absorbed within the OPEC countries.

It therefore becomes a challenge to the international community to devise a mechanism of financial intermediation so that this surplus from the OECD countries can be effectively transferred to the developing countries which can expand their deficits and absorb them through productive investments. In the mid-1970s the international community failed to devise such a mechanism. The OPEC surplus was largely recycled to the developed countries, and the intermediation of the international banks in favor of a few developing countries in an environment of zero, or negative, real interest rates dissipated itself in unsustainable investments. That phase of international financial interaction ended with the virtual disappearance of the OPEC surplus. But the world scene today is different. The OECD surplus is not likely to disappear, and a reduction in the deficits of the United States, which may be essential for sustaining the recovery, would only heighten the need for effective intermediation.

One lesson that has been effectively learned from the recycling experience of the 1970s is that the market is a poor performer in international financial intermediation. This should not have been unexpected because that experience with financial intermediation involved investment in developing economies, and the literature on the economics of development begins with imperfections in the capital market, where the "true" rate of return on investment is not reflected in the "appropriable" market rates of return or interest. If there is any area where the total approach of development programs determines the viability of the components of the program, it is in the investment activities in tradable products, especially in the industrial sector. If the market could allocate investable surpluses optimally, underdeveloped countries would not have remained underdeveloped.

This does not mean that financial intermediation should necessarily involve subsidization. That would not be feasible, because financial intermediaries, whether they are commercial banks or international institutions, have to pay reasonable compensation to private savers who, through capital markets in industrial countries, channel their savings to developing countries. But this points to the need for planning and coordination of policies. Projects should be so chosen that they are mutually supportive, thus increasing their viability. Sometimes, a prior or simultaneous investment in infrastructure, actively supported by concessional funding, can significantly increase the commercial return of a particular investment. In other cases, the viability of even an attractive commercial project may depend on a set of policies that a government can adopt only if it has balance of payments support over the medium term, or financial resources to undertake structural adjustment over a longer term. In these instances, financial intermediation, even on commercial terms, can be more effective if properly integrated with multilateral devel-

opment or balance of payments financing. Even the international banking system, which is now very reticent about lending to developing countries, can revive its activities if part of its risk is shared by the international community, either with a guarantee or through cofinancing by some international agency, or through financing of complementary projects with substantial backward and forward "linkages."

In other words, it is possible to devise appropriate mechanisms of international financial intermediation that would channel the growing surplus of OECD industrial countries to productive and viable investment projects in the developing countries. The essential prerequisite for that is an effective coordination of national policies of the countries concerned. The need for coordination of the policies of developing countries with those of the multilateral agencies has already been noted. The viability of investment projects financed by international resources would also depend upon the developing countries' ability to transfer investment incomes into foreign exchange, which would depend upon the growth of their exports, which in turn would be determined by the growth of the international economy and the reversal of protectionist tendencies. Indeed, the success of transferring international savings to the developing countries through financial intermediation is dependent on the process of recovery, supported by coordinated policies, and creating a basis for the world economy to grow with price stability.

This article began by noting that the current world recovery is slow and fragile. It has tried to show that the process need not be so, and that schemes could be envisaged that would sustain the growth of the world economy with stability and with benefits more evenly spread. The logic of these proposals is derived from the increasing global interdependence between the developed and developing countries. Growth scenarios, normally begin with the recovery and growth of the developed countries, leading to the growth of their imports from the developing countries, which, together with capital flows, determine the developing countries' import capacity, and this in turn determines their rates of growth. If, according to the above reasoning, an effective system of international financial intermediation can be developed, capital flows to the developing countries could be raised substantially, pushing up the import capacity and the rate of growth of these countries. The effect of the growth of the developing countries on the rise of exports from OECD countries, and consequently on their GNP growth, has not been always fully appreciated.

The recent OECD *Outlook* states that the experience of 1982, "when the decline of the OECD exports to the developing countries reduced OECD GNP growth by 1 percentage point or more, suggests that the adverse impact on the OECD countries themselves could well be of macroeconomic significance." The experience of 1982 was the result of the acute financing problems of the developing countries. If a better system of financial intermediation improves the growth of these developing countries, the positive results could be equally significant. F&D

Robert Townsend for F&D

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The West African Monetary Union An Analytical Review

by
Rattan J. Bhatia

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Resuming growth in Latin America

Despite recent difficulties, Latin America has an important weight in the world economy. The conditions for sustained growth, and the World Bank's role

A. David Knox

Despite the drop in production that followed the debt crisis of 1982, Latin America has very considerable weight in the world economy. The combined gross national product of Latin American countries is as large as that of Germany, and a fifth as large as that of the United States. In the long run, markets in the region can be expected to continue growing, if for no other reason than rapid population growth of about 2.5 percent a year.

Before the debt crisis of 1982, 18 percent of US exports went to Latin America. The economic contraction in Latin America reduced growth in the industrialized world by at least 1 percentage point and, as a result, some 400,000 jobs have been lost in the United States since 1982. Latin America's imports—half of which come from the US—are now far below their pre-crisis levels. Given the region's place in world trade and capital markets, a resumption of its growth is clearly in the interest of the world economy.

This article first reviews Latin America's progress in the past two decades, pinpointing areas of current policy that are crucial for future adjustment and the resumption of growth. It then describes the World Bank's work in the region.

Building economic power

The Latin American economies grew very rapidly after World War II, thanks to their immense natural resources (notably minerals, agriculture, and energy) and talented population. Between 1960 and 1980 production grew faster in Latin America than in the United States and for most people in the region the gap in income with the United States narrowed. Of course, different countries performed differently. Brazil, where over a third of the region's population lives, outperformed the other countries by a wide margin. But Colombia, Mexico, and Venezuela, as well as several smaller countries, improved income per person at least as fast as the United States.

This growth in incomes went hand in hand with considerable social improvements. During the 1960s alone life expectancy at birth, the most meaningful single indicator of welfare, increased from 56 to 64 years, which is not far below the average for middle-income European countries such as Greece, Portugal, or Yugoslavia. Only 40 percent of the population had access to safe drinking water in 1960; over two thirds have such access now. And by the late 1970s most Latin American children attended primary schools.

At the spearhead of economic and social progress were the middle classes, whose importance has increased throughout the region. One way to illustrate their rise is to look at the ownership of cars and television sets. In 1960 about 5 percent of families owned a car; by the late 1970s more than 20 percent did so. In Brazil and Mexico nearly 30 percent of families now own cars. More than one half of Brazilian families own a television set; even in the poor Northeast nearly 30 percent of families have TV. The rise of the middle classes has a direct bearing on Latin America's economic future, inasmuch as their political power—particularly on economic issues—has become very strong. As the recipients of subsidies on gasoline, electric power, housing, or interest rates that are

This article is based on a speech to the US Foreign Trade Banks Association on May 15, 1985 at Boca Raton, Florida.

made possible by increased borrowing, the middle classes often show themselves vociferously opposed to government plans for austerity measures.

Crisis and adjustment

The improvements described above were, however, interrupted. As the world economy entered into recession, export demand dropped and interest rates increased sharply; and, as commercial bank credits to Latin America were withheld in the wake of the Mexican debt crisis, most countries in the region had to adjust drastically.

The prospects for resuming growth in Latin America rest on both internal and external factors. Internal factors are of fundamental importance because they alone are within the power of governments and also because only successful internal adjustment can lead to sustained growth.

Adjustment is a word used in many different ways. In one sense adjustment is inescapable when external financing is curtailed and export demand falls, as was the case in 1982 and 1983. But a country can adjust in many different ways. It can cut imports or expand exports. It can reduce consumption and wages, or cut investment. It can raise taxes, or cut government spending. Usually elements of all these policies are combined. The particular combination chosen by a country strongly influences its prospects of sustained recovery.

In the first phase of adjustment virtually all Latin American countries had no choice but to reduce imports drastically. In the second phase some countries managed to expand exports more successfully than others. Brazil was most successful in this respect; its exports increased by nearly one quarter in value. The exports of Bolivia, Chile, Panama, and Uruguay declined while Peruvian exports stagnated. Differences in national export performance are strongly influenced in the short run by the composition of exports; Chile and Peru, for example, rely heavily on mineral exports for which world demand is now sluggish. But ultimately domestic policies, particularly exchange rate management, play a very important role. Brazil, for instance, has devalued its currency in real terms more than Mexico or Peru, both of whose exports performed poorly. Devaluation (and hence encouragement for exporters) is often avoided for fear it will exacerbate inflation. The potential conflict between stimulating exports and reducing inflation should not be underestimated, but it is nonetheless likely that failure to boost exports will eventually worsen rather than lessen inflation. Exports are vital for several reasons. First, while budget deficits are being cut and interest rates are high, exports provide one of the few, and in some countries the only, sound source of growth of output and employment. Second, exports are vital to improved debt-servicing capacity and to the restoration of creditworthiness. Third, since they add to the volume of production and hence make possible economies of scale, they stimulate improvements in productivity (see "Import substitution versus export promotion" by Anne O. Krueger, *Finance & Development*, June 1985). Improvements in productivity (in agriculture, mining, and services, as well as in manufacturing) are at the root of the long-term growth process.

Since the autumn of 1982 most countries in the region have implemented adjustment programs; many have reduced their budget deficits sharply and strengthened their external accounts. The region's current account deficit fell from $40 billion in 1982 to $3 billion in 1984, while its trade surplus increased from $9.6 billion to nearly $38 billion. In response to stringent cuts in imports in 1982 and 1983, the trade balance of the region's oil importing countries swung from a deficit of $900 million in 1982 to a surplus of nearly $14 billion in 1984.

Though the fight against inflation has been less successful than adjustments to government budgets and in trade, some Latin American countries have made substantial progress toward sustained growth. Other countries have yet to come to terms with the need for adjustment. For the region as a whole, progress is reflected in the transition from a decline in GDP in 1982–83 to growth of about 3 percent in 1984. This barely exceeds the rate of population growth, yet it is a welcome change in trend.

Prospects

The areas of policy that were crucial in the early 1980s will remain so in the years to come. Promoting exports requires continued attention to real exchange rates and to ways of rationalizing often stifling import restrictions. Further stabilization measures are needed to strengthen domestic capital markets, to bring down real domestic interest rates on a sustained basis, and thus to encourage productive investment. Not only is it necessary to reduce public deficits further but also to harness better the tremendous power of the public sector for development. Doing so will require rational decisions on public investment and hence, often, improvements in the structure of public sector management, as well as sustained political courage.

External factors are also vital. Domestic policies can enable a country to take advantage of improving world circumstances, but in general they cannot be expected to generate sustained growth and employment if external forces are adverse. This is truer now than before, because of the enormous weight of Latin America's external debt—of about $360 billion as of June 1985. On average for the countries of the region, interest payments alone represent some 35 percent of exports of goods and services. Adding amortization on long-term debt to the interest payments due increases the burden to nearly 70 percent of exports in Argentina, nearly 60 percent in Brazil and Chile, and nearly 50 percent in Mexico. The rescheduling exercises—of which there have been more than 20 since August 1982—have helped alleviate the debt-service burden, and so have gradual reductions in spreads over the London Interbank Offered Rate (LIBOR) and in the commissions paid on both rescheduled and new debt.

Two questions persist, however:

- Are there prospects for resuming sustained growth when so large a share of export earnings (and, perhaps more important, so large a share of domestic savings) must be transferred abroad?
- Even if technically feasible, for how long can transfers be sustained before the social and political fabric of society breaks down?

Numerous projections have been made. To mention only a few, the International Monetary Fund, the Federal Reserve Bank of New York, the Institute for International Economics, Morgan Guaranty, and the World Bank have all independently prepared scenarios for the next five to ten years. (On the World Bank's scenario, see "International capital flows and economic development" by Francis X. Colaço in this issue—Ed.) Consensus exists on two points: on the factors that are considered to be of crucial importance and on the assumptions under which sustained growth is feasible.

The crucial factors are obvious: first and foremost, the rate of growth of the industrialized countries and the related growth of world trade; second, the level of real interest rates; and third, the availability of external capital. There are other important factors, chiefly the trade policies of the industrialized countries. Most of the analyses referred to above imply that Latin America could resume sustained growth of 5 to 6 percent a year starting in 1987 or 1988 if the following external factors materialize: growth in the industrialized countries of 3 to 4 percent a year; LIBOR at 9 to 10 percent with global inflation of 5 to 6 percent a year; increases in commercial bank debt of 5 to 6 percent a year in current terms, at least through 1990; and no increase in protectionism in industrialized countries.

These magnitudes differ little in essence from those of the recent past. The growth of the combined GDP of industrial countries accelerated from 2.5 percent in 1983 to nearly

5 percent in 1984, to a large extent reflecting an increase of almost 7 percent in the GDP of the United States. GDP also increased in Japan and in Western Europe, from 3 percent and 1.5 percent, respectively, in 1983 to 6 percent and 2.5 percent in 1984. World trade expanded by 2 percent in 1983 (after a 2 percent drop in 1982) and increased by 9 percent in 1984. LIBOR averaged 9.9 percent in 1983 and rose to 11.2 percent in 1984. Net inflows of capital to Latin America, after declining from $19 billion in 1982 to $4.4 billion in 1983, rose to about $11 billion in 1984. Medium- and long-term external debt, including the consolidation of short-term credits with medium-term debt which took place in 1984, increased by an estimated 6 percent. While most of these developments are close to those of the projections, the uncertainty surrounding growth in the industrialized countries, and particularly in the United States, which has special importance for Latin American exports, casts a shadow over the region's growth prospects.

Furthermore, protectionist pressures are not abating. The prospects for liberalizing restrictions on imports from Latin America are not promising, given the disagreement between industrialized and developing countries that surfaced at the Development Committee meeting in April 1985 and some hesitation about trade talks among industrialized nations. Trade liberalization is an important ingredient of economic adjustment in the industrialized nations themselves, and it is to be hoped that the momentum for a new round of global trade negotiations will not abate.

There remains the question of future capital flows to Latin America. Unless sufficient external capital is made available to countries that are following sound adjustment policies growth will falter, the risks of political unrest may increase, and the burden of debt servicing will grow once again. The international financing institutions have already raised their disbursements to the region, and whether they can raise them further will probably depend on their own capital increases. The World Bank disbursed $3.2 billion in Latin America in 1984, and the Inter-American Development Bank, $2.2 billion. On a net basis this amounted to $4 billion. Official export financing agencies also provide net lending of $1–2 billion a year. But altogether net official flows amount to only slightly over one percent of the region's outstanding debt. The difference between these inflows and the amounts required in the projections must continue to be forthcoming from commercial banks if sustained economic growth is to be resumed.

Because growth must be driven by exports, for the reasons given above, a sound commonality of interests exists between the Latin American countries and the commercial banks: as exports expand, so does growth and employment creation, while creditworthiness improves. Countries that are more successful in their economic management will become better credit risks and will be more likely to attract external capital. All the projections mentioned above show that as growth resumes the ratio of debt to exports—a crucial indicator of creditworthiness—declines and so does the burden of interest payments on export earnings.

This outlook assumes that commercial banks will not pull out of Latin America. The Bank's projections assume that the commercial banks should be able to reduce the Latin American share of their total assets while still increasing these assets by 5 to 6 percent a year in current terms, as noted above.

Until now, Latin America's interdependence with the rest of the world has led to remarkably close cooperation between the commercial banks, the International Monetary Fund, the World Bank, the Inter-American Development Bank, the monetary authorities of major industrial countries, official export credit agencies, and, most important, the governments of the region. This cooperation has not been easy; the term "involuntary lending" is witness to the difficulties that had to be overcome. But without it, it is doubtful whether the region's turnaround would have occurred. Projections suggest that the debt burden will remain heavy for many years to come. The room for maneuver will be very narrow. And thus the need for close cooperation will continue.

World Bank's role

The Bank now offers a variety of assistance in Latin America. Traditionally, the Bank mainly invested borrowed funds in development projects in poorer countries, ranging from hydroelectric power plants, highways, ports, and pipelines, through factories, schools, and hospitals. Nowadays the Bank also finances credit programs for industry and agriculture that channel funds to private enterprises. Most of the investment projects supported by the Bank take several years to construct and all require complementary financing—because the Bank never finances 100 percent of a project, usually supplying only one half or less.

In recent years it has become clear that many countries lack the complementary fiscal resources needed to finance investments; furthermore, they acutely need external funds that can be disbursed quickly. In response the Bank has adopted a number of measures. First, it now devotes a small proportion of its lending to supporting macroeconomic and sectoral policy improvements, through fast-disbursing "structural adjustment loans" which are not tied to a particular investment project. The most recent examples in Latin America and the Caribbean are in Costa Rica and Jamaica. Where progress is apparent and further support is needed, several structural adjustment loans may be made consecutively, as has been the case in Jamaica.

Second, the Bank now makes sector loans to support policy improvements in important individual sectors of an economy. Large sector loans are supporting export development in Brazil and Mexico; they have financed badly needed raw materials and intermediate goods required by industrial exporters and have supported policy changes designed to make exports more attractive. The Bank has also made an agricultural sector loan to Brazil, after the government decided to reduce drastically its subsidies on farm credits, which had been a major source of inflation and economic distortions. A new sector loan of $300 million to Colombia will support the first phase of the government's trade adjustment program. The program's first objective is to promote exports, through measures to ease exporters' access to imported inputs, rationalize import restrictions in general, and eliminate most export restrictions. The program will also improve the administrative mechanisms for trade management and formulate an action program for longer-term trade reform. The loan will be disbursed in two tranches; progress with the adjustment program will be closely monitored by the Bank, giving attention to trade policy performance and to the level and composition of public investment, which has crucial implications for future development. Other sector loans are contemplated for a number of countries.

Third, the Bank has accelerated disbursements of traditional loans in countries that meet certain performance criteria. The new procedures for this purpose include front-loading, that is, disbursing more during the first year or two of a project and correspondingly less in later years, as well as increases in the share of costs financed by the Bank.

The three types of changes just described have made it possible to increase Bank disbursements to Latin America and the Caribbean from $2 billion in 1982 to $2.5 billion in 1983, and $3.2 billion in 1984.

Meanwhile, the Bank has established closer relationships with commercial banks and continues to seek commercial bank cofinancing for its projects. Cofinancing has become more difficult to arrange since the advent of "involuntary lending" but it is still important and may become even more so as countries restore their creditworthiness. Under some cofinancing arrangements the World Bank participates in a syndicate to finance so-called B-loans. In some B-loans the Bank will pick up or guarantee the outer-year maturities.

Or, as in the case of a cofinanced loan to Paraguay, the World Bank may (within a certain range) translate future interest rate fluctuations into changes in loan maturity and assume a contingent liability for the loan principal which might be deferred.

The Bank's lending program and its policy recommendations are tailored to the individual circumstances of its borrower countries, and arise out of dialogue with the countries' authorities. All of this work requires an in-depth knowledge of borrower countries. The Bank devotes some $6 million a year to economic and sector studies of Latin American and Caribbean countries—probably more than any other development or commercial institution in the world. It has recently stepped up its analysis of the public investment programs of some of the Latin American countries, and is also placing great emphasis on reviews of the productive sectors. Finally, the Bank has acquired considerable experience of particular public institutions in Latin America, and has helped to strengthen some of them.

Some of the initiatives mentioned are still new and may evolve quite rapidly. In addition, the Bank is seeking ways to monitor development policies and performance that will give information useful for mobilizing complementary sources of finance. One example is the structural adjustment loan to Costa Rica, where commercial bankers and other lenders (notably the US Agency for International Development) have tied their disbursements to those of the Bank, using the Bank's monitoring. Similar approaches are being explored in other countries. At all stages of its efforts to mobilize complementary financial support for particular countries, the Bank works very closely with the Fund.

Conclusion

Latin America has become so important a part of the world economy that it has become a matter of self-interest for the industrialized world to help finance adjustment programs in the region. In the Bank's judgment, the incipient recovery may lead to sustained growth in Latin America well before the end of this decade, while creditworthiness improves. Such progress could be achieved if growth in the industrialized countries reaches 3 to 4 percent a year; if interest rates remain around 9 to 10 percent; and if the international financial community continues its support. Such support is consistent with a gradual reduction in the Latin American share of commercial bank portfolios. However, increased protectionism could frustrate a recovery. Continued close cooperation between governments, the commercial banks, the Fund, the Bank, and other important actors will be absolutely essential in the years to come.


Michele Iannacci for F&D

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Adjustment efforts in sub-Saharan Africa, 1980–84

Fund-supported stabilization programs during a difficult period

Rattan J. Bhatia

The economic and financial situation of many African countries began to deteriorate sharply after the mid-1970s. The weighted average annual rate of economic growth of the non-oil countries in sub-Saharan Africa (excluding South Africa) fell from 4 percent in 1974–76 to only 1 percent in 1981–83. Simultaneously, their combined current account deficit almost tripled from $4.5 billion in 1973 to $12.2 billion in 1981 before declining to $8.9 billion in 1983, with a further decline estimated for 1984. To finance their large and growing deficits, a number of these African countries resorted to foreign borrowing which, until the late 1970s, was facilitated by relatively easy access to international financial markets. As a result, the combined external debt of sub-Saharan African countries grew from less than $10 billion in 1973 to about $56 billion in 1984, and the debt-service ratio almost tripled to about 20 percent of exports of goods and services.

The causes underlying these unfavorable developments have been discussed extensively in recent years (see, for example, "Adjustment programs in Africa" by Justin B. Zulu and Saleh M. Nsouli, *Finance & Development*, March 1984). In brief, the first general shock emanated from the 1973–74 oil price increases that were followed by further sharp increases in 1979–80. The 1973–74 oil price increases were accompanied by a sharp but short-lived increase in the international prices of African export products. This followed an improvement in mineral and primary product prices during the late 1960s and early 1970s, prompting many African countries to embark on expansionary fiscal policies after 1973 and, in many cases, to protect domestic consumers from the increases in the prices of oil and other essential commodities through an extensive system of consumer subsidies. Unfortunately, these domestic policies were continued even when the countries experienced a collapse in the export prices of their products (coffee, cocoa, phosphates, iron ore, etc.) and had to finance the resulting external deficits through foreign borrowing. Most of this borrowing was denominated in dollars, and the substantial depreciation of the dollar in the mid-1970s prevented the adverse impact of their international borrowing from becoming immediately evident to the African countries. This encouraged the authorities to postpone adjustment and to continue financing their growing deficits with additional external borrowing.

Beginning in late 1979, when the effects of the world-wide recession began to emerge, the prospects for African countries took a turn for the worse. Their difficulties became further entrenched after the second oil price shock of 1979–80. An immediate result was a fall in export prices of commodities that further aggravated the problems of African exporters. Higher interest rates and the subsequent appreciation of the dollar added to the financial burden of servicing the ex-

ternal debt of African countries, thus compounding their difficulties.

It was after 1979 that the Fund's involvement in Africa became both financially important and geographically widespread. The role of Fund-supported stabilization programs in the adjustment efforts of African countries can be examined broadly in two phases: 1980 to about mid-1983, and the period after mid-1983, the first phase beginning with the world recession, and the second including the full impact of the second oil price shock, and the emergence of the debt crisis.

Fund-supported programs: Phase I

As mentioned earlier, initially the sub-Saharan African countries had relied on external borrowing while postponing adjustment. However, as their debt reached important proportions ($36 billion at end-1979 compared with $10 billion at end-1973), external financing from commercial sources became increasingly more difficult to obtain and more expensive, and the increase in official aid was insufficient to fill the gap in the balance of payments. African countries, therefore, began to perceive the need to undertake adjustment efforts with technical and financial assistance from the Fund.

During 1980–81, 21 countries in sub-Saharan Africa established financial programs with the Fund. Of these 21, 6 were in the form of extended (three-year) arrangements and 15 were stand-by arrangements. The amounts agreed under these arrangements were $1.5 billion in 1980 and $3.9 billion in 1981, of which $463 million and $1.4 billion were disbursed respectively in the two years. Such large amounts of financial assistance were made possible by enlarging countries' potential access to the Fund beyond the traditional maxima permitted under the stand-by or extended arrangement. The general presumption of these programs (a third of which were under the extended Fund facility) was that the balance of payments problems of the African countries were of a short-term nature and could be reversed by implementing suitable adjustment policies. Of course, in some cases, the problems were also seen as emerging from structural weaknesses that had hampered growth and hence prevented the attainment of a viable balance of payments. In these cases, the Fund was prepared to use its extended facility, which had been established earlier to address such problems.

The design of the programs in the earlier part of this first phase emphasized demand-management policies, though in the extended arrangements specific supply measures were also introduced. This was because the emerging payments problems were at least partly attributable to expansionary policies that had encouraged consumption and imports. The basic emphasis was on reducing budgetary deficits, identified as the main contributing expansionary factor. As the authorities had allowed imports to rise, the inflation rates were generally moderate and cost-distortions limited. Accordingly, in the initial phase, exchange rate adjustments did not appear to be required on comparative cost grounds. Of the 14 arrangements in force in 1980, 6 involved an exchange rate adjustment, while in 1981, exchange rate adjustment was included in 8 out of 19 cases. In the area of interest rates, time deposit rates were raised and made positive in real terms in only a few arrangements in 1980 and 1981. On the other hand, in all cases the programs aimed at reducing the budgetary deficit and established separate subceilings on bank credit to government.

Change in analysis, programs

In 1982, a major change took place in the approach to the nature of difficulties confronting sub-Saharan African countries. It was realized increasingly (especially after the impact of the 1980 oil price increase was fully felt) that the balance of payments problems of these countries had become intractable, and were likely to be of longer duration than initially thought. Different solutions had to be examined. Strengthening this realization was the fact that the 1980–81 programs had been disappointing as regards their balance of payments results; in 1980, about 20 percent of the programs attained their external current account targets, while in 1981 40 percent reached the target. In 1980, of the 9 country programs with specific growth targets, only 3 attained or surpassed the growth target, while in 1981 only 4 out of 14 reached the target. The attainment of the inflation targets was somewhat better: 3 out of 10 countries in 1980 and 10 out of 15 in 1981.

Despite the improvement, this result was disappointing and was only partly attributable to exogenous circumstances. It was largely due to the inability (or unwillingness) of the national authorities to carry out the intended policies. For instance, the budgetary deficit target was respected in only 30 percent of the programs in 1980 and in 27 percent of the programs in 1981. The performance for overall credit expansion was better, conforming with the ceilings in 70 percent of the programs in 1980 and 60 percent in 1981; but this also implied that excessive credit to the government crowded out the often fledgling private sector, with an adverse impact on growth. Finally, the authorities found it difficult to implement structural policies, such as reform of state enterprises, tax reform, etc., agreed under extended Fund arrangements.

For all these reasons, the Fund's approach to the design and implementation of adjustment programs changed in several important directions. Given the longer-term uncertainties and the difficulties that national governments had experienced in committing themselves to longer-term policies, one-year stand-by arrangements, rather than three-year extended arrangements, became the Fund's preferred approach to the adjustment programs. These arrangements gave countries the flexibility to adjust policies to changing circumstances from year to year, as they progressed from one stand-by arrangement to another. Also, in light of the disappointing results of the initial years, the programs placed greater emphasis on prior implementation of policies that were regarded as crucial for the success of the program, before the Fund would approve a stand-by arrangement.

Further, demand management policies alone could not be regarded as sufficient to overcome the widening payments deficits resulting from the adverse shift in the terms of trade, and greater emphasis than before had to be placed on other measures. In general, while demand-management measures continued to be used to help reduce budgetary deficits, the new Fund-supported programs in Africa encompassed a wider set of policies to increase supply and exports. To improve monitoring during the course of the program, the new arrangements also included one or more reviews during each year. Finally, because the external deficits of individual countries had become large and the resources of the Fund had been depleted by the increased lending undertaken in the previous years, the Fund had to supplement its resources through borrowing. These resources were borrowed at market-related rates, increasing the average cost of the use of Fund resources by member countries.

The policies within Fund-supported programs became more comprehensive, and the adjustment period was extended to the medium term to allow countries to achieve viable balance of payments positions gradually. Despite the apparent contradiction, there was no clash between the emphasis on the medium-term approach and the shift away from extended arrangements to one-year stand-by arrangements. The medium-term approach fixed targets to be achieved over the agreed period, leaving policies to be decided and adjusted annually. Extended arrangements, however, tended to fix policies for the duration, making them more difficult to implement in a changing environment and requiring modifications to be negotiated.

On the demand-management side, the continuing emphasis on reducing budgetary deficits was reinforced by appropriate actions in individual areas of revenue and expenditures. Fund-supported programs paid special attention to policies on public employment

Fund-supported arrangements in effect with non-oil sub-Saharan African countries at year end, 1980–84

	1980	1981	1982	1983	1984
Central African Republic	S			S	S
Equatorial Guinea	S				
Ethiopia		S			
Gabon	E	E			
The Gambia			S		S
Ghana				S	S
Guinea			S		
Ivory Coast		E	E	E	S
Kenya	S	S	S	S	
Liberia	S	S	S	S	S
Madagascar	S	S	S		S
Malawi	S	S	S	E	E
Mali			S	S	S
Mauritania	S	S			
Mauritius	S	S		S	
Niger				S	S
Senegal	E	S	S	S	
Sierra Leone		E			S
Somalia	S	S	S	S	
Sudan	E	E	S	S	S
Tanzania	S	S			
Togo		S	S	S	S
Uganda		S	S	S	
Zaïre	S	E		S	S
Zambia		E		S	S
Zimbabwe		S		S	

S Stand-by arrangement
E Extended Fund facility

and subsidies (both consumer and producer subsidies) not only because they constituted a large proportion of budgetary outlays and thus contributed to budget deficits, but also because they had a detrimental effect on domestic savings. On the supply side, a greater number of programs included specific actions and understandings on the exchange rate, price liberalization and adequate producer incentives, interest rates, and reform of public enterprises. But the approach continued to be tailored to the situation of each country. For example, contrary to popular belief that *all* Fund-supported programs include a change in the exchange rate, of the 20 stand-by arrangements in sub-Saharan Africa during 1982 and the first half of 1983, only 12 included exchange rate action. Greater emphasis on exchange rate policies, in countries that needed to adjust their currencies, was based on the realization that these rates had become seriously overvalued, making it difficult to put in place an appropriate incentive structure for production. Overvalued exchange rates prevented the needed improvement in the balance of payments by making exports uncompetitive and encouraging imports. Accelerating inflation had made real interest rates negative in many countries, thus discouraging savings and promoting a misallocation of resources. As a result higher interest rates were sought in many arrangements to achieve positive returns in real terms.

Experience with the new programs in 1983, although not satisfactory, was better than in the previous year. Growth targets were actually attained in about half of the programs, as were the targets relating to the current account deficit in the balance of payments. The budgetary situation showed an improvement over the previous year in a greater number of cases than in the earlier period, and credit targets were adhered to in over two thirds of the programs for overall credit, and about half for credit to government. However, as the content and requirements of the arrangements with the Fund became more comprehensive, the number of countries with which stand-by arrangements were concluded initially declined, from 15 countries in 1981 to 12 in 1982. Only three new countries concluded arrangements with the Fund in 1982, compared with seven in 1981.

Phase II: debt and capital flows

A second phase of stand-by arrangements followed the onset of the Mexican debt crisis in September 1982, which later spread to Argentina, Brazil, and many other Latin American countries, drawing world-wide attention. The debt problem of the African countries was no less acute. By 1982, the external debt of non-oil sub-Saharan African countries (excluding South Africa) reached nearly $50 billion, and their average debt service ratio was 25 percent. Within this average, there were several countries whose debt-service ratio to exports of goods and services reached 50 percent or higher.

The emergence of the debt problem in Latin America, and the assumption of a coordinating role by the Fund to contain and resolve the problem, meant that the demand on the Fund's resources became more widespread and the amounts required, larger, at a time when the Fund's own liquidity was becoming constrained. This meant either that adjustment programs had to be made even more restrictive, limiting the acceptable external deficit to the amount a member country could borrow from the Fund, or that Fund resources had to be supplemented with financial support from other external sources. Given the large external debt problem facing African countries, and the higher cost to them of using Fund resources (which included borrowed resources), it was not considered desirable that the entire balance of payments gap should be filled by the Fund. In many cases, the size of the payments imbalance was such that it could not have been fully financed during the course of a suitable adjustment program by Fund resources alone.

Accordingly, over this period evolved the concept of "gap filling." This meant that the financing of the gap under a Fund-supported program had to be guaranteed *ex ante*, for the Fund's stand-by arrangement to become effective and for a member country to use Fund resources. Since such financing involved many parties (the member country, the commercial banks, the official creditor and donor institutions and governments), the Fund programs became a broad cooperative effort.

The debt problem also focused attention, more sharply than in the earlier period, on the medium-term viability of the balance of payments of member countries. It was recognized that Fund resources were available for only a short period (normally 3–5 years, in keeping with the revolving nature of the Fund's resources), and that, in view of the mix of regular and borrowed resources, they were being made available to member countries on costlier terms. This inevitably meant that even greater emphasis had to be placed on structural policies to go hand in hand with the short-term stabilization efforts. In this exercise, the Fund relied heavily on the World Bank to provide its assessment on a country's public investment program and on microeconomic policies in certain sectors.

By 1983 (and more so in 1984), many African countries had become prolonged users of Fund resources (having continuously used these resources for over 3–5 years) or were likely to become such. Further, while some prolonged users were expected to achieve viability in the balance of payments within a foreseeable, albeit longer, period, others were not. In principle, at least, this latter set of countries should not have been using Fund resources as they would inevitably encounter difficulties when repurchases (i.e. repayment to the Fund) began to fall due three years after use of Fund resources.

In 1984, the total amount of the 14 agreed stand-by arrangements with sub-Saharan African countries was SDR 1.1 billion, of which SDR 488 million was drawn, compared to SDR 2.3 billion and SDR 1.3 billion respectively in 1983. As the African countries also made repurchases, net purchases totaled some SDR 400 million only.

During 1985 and subsequent years, African countries will need to make substantial repurchases from the Fund in respect of purchases made since 1980. This raises the prospect that, at a time when the world is becoming more aware of the problems of sub-Saharan Africa and is trying to allocate more resources for African development, the Fund may be withdrawing resources on a net basis—a contrast to the reasoning that prompted the Fund's active involvement in Africa, beginning in 1980. Is the Fund right in taking this posture? First, the Fund is not a development agency and its resources have a revolving character that needs to be maintained if the Fund is to discharge its assigned responsibilities. Second, the Fund should be regarded as one of the many sources of international finance, and the international community, as a whole, should endeavor to attain positive net inflow into sub-Saharan Africa. As the experience of the past two years shows, the Fund, along with the World Bank, has been very active in mobilizing those efforts at international assistance. In these endeavors, the Fund continues to help its member countries in their adjustment efforts and to encourage an environment for a smoother and increased flow of international resources to those countries. Finally, while African countries that have made large use of Fund resources in the past may be making net repurchases, it is by no means certain that other African countries will not use the Fund's facilities and, thereby, reduce if not reverse the net repurchase possibility for sub-Saharan Africa as a group.


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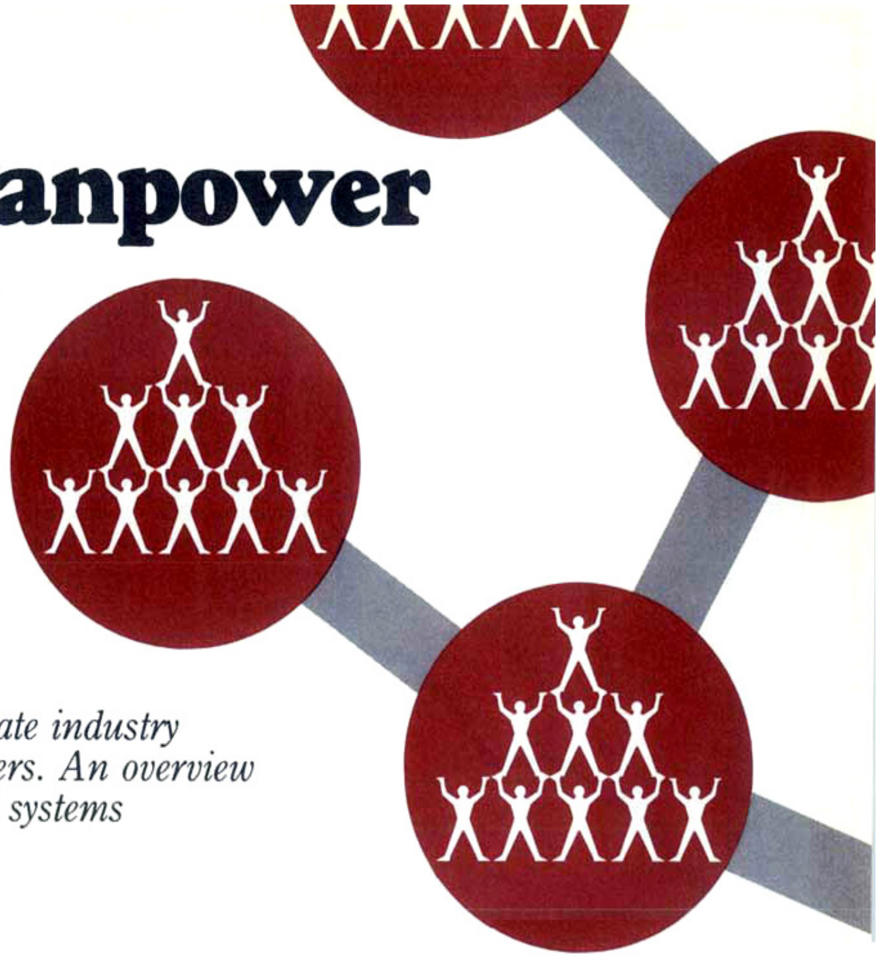
Catalytic role

The Fund has remained conscious of the need to encourage adjustment efforts and to act as a catalyst in attracting international financial support for such efforts. In this role, the Fund negotiates a stand-by arrangement with a country in support of an adjustment program that foresees an external deficit larger than the Fund could, or is prepared to, finance. It makes the activation of such an arrangement dependent on the assurance that the gap would be filled by donors and creditors. On the basis of such a program, the country concerned obtains debt rescheduling from its official and commercial creditors, and donor assistance within the framework of a multinational donors' conference, usually chaired by the World Bank but in which the Fund staff participates actively. Over the short period of experience with such efforts, a tradition has grown that such exceptional financing is received only after the country has negotiated a stand-by arrangement with the Fund.

The bringing together of such a varied number of donors and creditors makes it imperative that the Fund negotiate a program that is credible enough to attract the needed support, and its strength is no longer a function of the amount the Fund is able to provide. Thus, the more recent programs have placed greater emphasis on the medium-term link between the annual programs, usually through the requirement that during the last review of a program, understandings be also reached on the main policy stance for the following year.

Perhaps a major contribution of the Fund over the past five years is not the resources it has provided to African countries in support of their adjustment programs, but the fact that those countries have recently come to accept the need for implementing adjustment policies. This is in marked contrast to an earlier resistance to adjustment altogether. This change in attitude should make even a smaller level of international assistance that much more efficient and effective.

Industrial manpower development in Japan



How the Japanese Government and private industry complement each other in training workers. An overview of the underlying social and educational systems

Shigeko M. Asher and Ken Inoue

By the early 1970s Japan had attained a level of per capita GNP comparable to that of the major industrial countries. Although there was a temporary setback during the post-oil shock adjustment in the mid-1970s, Japanese industry, especially manufacturing, increased its labor productivity (output per manhour) at a higher rate than other leading industrial nations—its labor productivity in manufacturing rising from an index value of 100 in 1970 to about 160 in 1978, compared with below 140 for the Federal Republic of Germany and about 126 for the United States (see chart). A probable cause of this rapid increase was the relatively high level of private capital investment that made rapid technological innovation and upgrading possible. Another factor, which may be difficult to quantify but is well recognized as important, was the availability of competent industrial manpower and the way it was managed.

This article describes the nature and effectiveness of the Japanese approach to developing manpower for its industry. Many countries in the East Asian and Pacific region are industrializing rapidly with a resultant change in the structure of their output and employment. Their supply of industrial manpower, however, is lagging behind demand. These countries, and others that have shown an interest in emulating the Japanese experience, may profit from an understanding of the way Japanese industry trains its manpower.

The Japanese approach should, however, be understood within the context of its culture and society since they play an important part in the Japanese training and employment systems. The Japanese experience may not be transferable easily to a country without a similar, supporting cultural and social structure. Lessons for developing countries that emerge from the Japanese experience are the stress placed on well-funded and disciplined formal education to supply useful "raw materials" to industry—a common characteristic of advanced countries; the active role of industry in its personnel development; and integration of personnel training and management by industry.

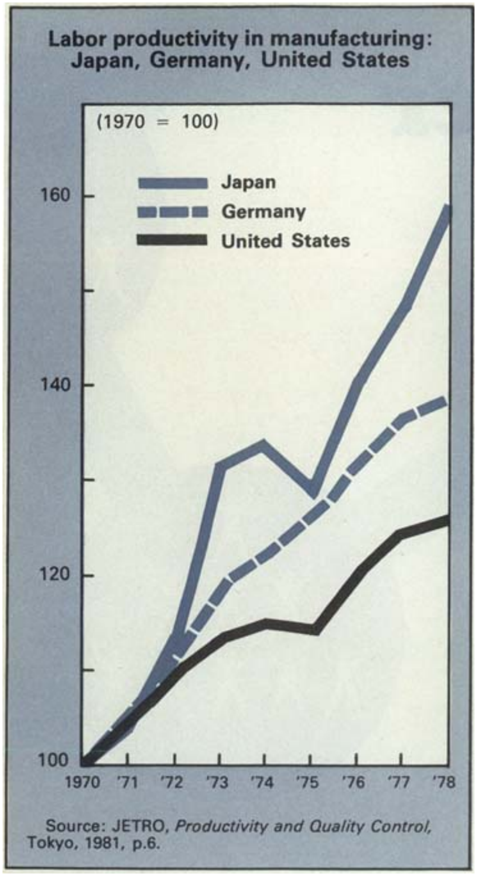
Broad central direction

Education is the foundation of the modern workforce. This is especially so in Japan. Schools, colleges, universities, and companies in Japan do not operate according to rigid central plans for manpower supply and demand. Instead they respond to broad guidelines and perspectives set out by the central government and operate according to information flowing in from all segments of the society.

The central government sets forth a broad perspective for national development. For example, the Economic Planning Agency, in its *Outlook and Guidelines for the Economy and Society in the 1980s* (August 1983), defined the purpose of its plan as follows: "An economic plan is not designed to provide detailed regulations governing all economic and social fields. Nor is it aimed to be implemented rigidly and forcibly. Rather the economic plan is fundamentally aimed at (i) clarifying a prospect of the desirable and realizable state of the economy and society; (ii) defining the basic economic policies to be pursued by the Government in the medium- and long-term periods and spelling out priority policy goals and ways to attain them; and (iii) providing guidelines for the household and business activities." Referring to formal education, public vocational training, and employer-sponsored training, the Government plan provides the basis for measures to be taken by local governments and the private sector in conjunction with the Government to educate people according to the needs of the economy.

Shared responsibility

In accordance with the Japanese Government's plan, government and industry complement each other in the training and development of industrial manpower. Education programs under the Ministry of Education supply industry with secondary school and university graduates possessing basic general knowledge and skills. Graduates from five-year technical colleges and science and engineering faculties of universities enter employment with specialized training. Programs under the Ministry of Labor and the Small



Source: JETRO, *Productivity and Quality Control*, Tokyo, 1981, p.6.

and Medium Enterprises Agency provide a variety of technical and managerial training, including basic and higher-level courses for new school leavers, and employed and unemployed adults. These programs aim to meet the needs of smaller enterprises whose resources are too limited to organize training programs on their own. With these "raw materials," Japanese industry conducts training specific to its requirements, either on-the-job or through specialized institutions.

The Ministry of Education administers an education program consisting of a 6–3–3–4 system, corresponding to the number of years spent in primary, secondary, upper secondary, and higher levels of education respectively. The financing and management of schools, colleges, and universities is shared by national and local governments, and the private sector. In particular, over 75 percent of university and about 30 percent of upper secondary school students are enrolled in private institutions. Local authorities and private agencies account for over 70 percent of education expenditures in the country.

Almost 100 percent of the 6–15 age group receive nine years of compulsory education at the primary and secondary school level; about 95 percent of the 15–18 age group are enrolled in the three-year upper secondary schools, making secondary education virtually universal. Higher education institutions enroll nearly 40 percent of the relevant age group. Compulsory education emphasizes general and moral education with nearly 70 percent of the time spent on general subjects and about 30 percent on physical and moral education. Vocational courses are conducted at upper secondary technical high schools but the proportion of students enrolled in those courses declined from 40 percent in 1955 to 30 percent in 1983. This fall largely reflects industry's preference for general education school leavers and students' response to that preference. Only one third of the students who selected technical high schools later found that their occupation was somewhat or highly related to the subjects they had taken, according to a survey by the Ministry of Education.

With the major exception of recently introduced technical colleges and engineering departments, higher education institutions also emphasize general education. There is not much demand for specialized post-graduate programs in Japan; only about 4 percent of university students are enrolled in masters and doctorate programs, half the proportion of similar students in the United States, for example. Technical colleges, based on a pre-World War II model, were reintroduced in 1962 as special institutions to promote science and technology. These colleges are linked to lower secondary schools and conduct five-year courses with nearly 60 percent of the time devoted to specialized education, compared with about 40 percent at upper secondary technical high schools and universities. Technical colleges produce high quality shop-level supervisors with a higher degree of maturity since they enter employment around the age of 20 instead of 18. University engineering education is conducted in line with the Government's industrial policies and requirements. About 85 percent of the engineering graduates obtain jobs as specialists in their fields, while less than 5 percent of graduates in the humanities and social sciences, who comprise over 50 percent of total enrollments in higher education, find employment in their areas of specialization.

According to the National Vocational Training Law, vocational training is classified into public vocational training administered by the Ministry of Labor and authorized vocational training conducted by a single enterprise or an association of enterprises. There are four types of public vocational training conducted at five types of institutions (see box).

The total number of annual trainees—including those who are employed and those who are looking for jobs—in training institutions run by the Ministry of Labor is about 300,000. This is quite insignificant when compared to, for example, the labor force in manufacturing alone, which was about 12 million in 1980. Moreover, the training capacity has been declining: places for basic training fell from 60,000 in 1973 to 49,000 in 1980.

The Vocational Training Law allows prefectural governors to authorize employers, their associations, juridical persons, or trade unions to establish vocational training schools, junior vocational colleges, or skill development centers when such individuals or institutions meet the prescribed standards. Of enterprises that conduct authorized vocational training, only a small number are relatively large, single, enterprises that provide the training by themselves. Most are smaller and conduct training jointly within associations. National and prefectural governments provide various types of assistance and incentives for both employers and employees undertaking authorized vocational training. The assistance and incentives include traineeship loans, training allowances for the unemployed, financial assistance to smaller enterprises with less than 300 employees (in retail and services less than 50, and in wholesale less than 100), professional advisory and institutional services, and incentive grants for paid educational leave.

In addition to the Ministry of Labor, the Ministry of International Trade and Industry assists smaller enterprises through the collaboration of its Small and Medium Enterprises Agency and local governments. These activities fall under three categories: (1) management guidance provided at prefectural level; (2) training conducted at two institutes of the Japan Small Business Corporation (JSBC) located in Tokyo and Osaka; and (3) dissemination of management information through 36 Small and Medium Business Information Centers in the country.

These training activities are unique in origin, target group, curriculum development, and financing. JSBC institutes were created at the request of small- and medium-sized firms (that absorb about 80 percent of the Japanese labor force), which felt an urgent need for workers' training to keep up with new technology and management processes. There is no apprenticeship training in Japan except for a few traditional, independent, artisan jobs. Smaller firms that basically depend upon training on the shop floor have therefore sought government assistance. This is why JSBC institutes train only management and employees of small businesses and local government officials in charge of providing guidance to small- and medium-size enterprises. The selection of courses and their contents involves close consultation with firms through frequent questionnaires and feedback from previous participants in the courses. Since smaller firms have very diverse needs, JSBC institutes provide several tiers of programs and different management courses.

Day-to-day operational expenditures are shared by the central government (75 percent) and firms (25 percent).

In spite of government and government-assisted programs for industry, the scope of authorized vocational training and small business training is very limited, and similar to that of public vocational training. For instance, the enterprises that have established authorized training institutions individually or as an association only account for less than 2 percent of enterprises in Japan, and small business institute training is conducted at present only at two locations for about 4,500 trainees in management and about 2,000 in technical courses annually. The implication is that most of the vocational training in Japan is conducted not by government or with government assistance, but by private industry.

Training by private industry

A company is regarded as a *Dojo* (a training place where one practices martial arts) of life. Every activity in a company is therefore considered part of the training for employees at all levels. It includes not only on-the-job training and study seminars, but also formal and informal meetings at different levels, moral lectures from the president, and private counseling.

There are basically two training methods, on-the-job and institutional. On-the-job training is provided by almost all companies since it is considered practical and useful. It can be conducted individually, based on one's needs and personality; it can be provided any time and anywhere; it also builds close human relationships between staff and their supervisors. Institutional training is based on a systematic curriculum for a certain period in a class. It is provided either by a company, an association of companies, formal educational institutions, or specialized management institutions. The training provided by the last three groups is normally used as a supplement to the first. Institutional training within a company has two programs, "specialized" and "stratified." The specialized program is open to all employees according to their needs, and includes computer skills, foreign languages, and safety training. The stratified program is provided to employees in the same positions.

The content and methods of specialized technical and skill training are not unique to Japanese industry. Many of them have been borrowed from other countries. What is special is the high degree of emphasis placed on attitudes and morale of workers, and the long-term perspective of training. For example, as part of the stratified training program, a company organizes one or two weeks of intensive training for all new employees. This orientation program introduces them to the company and provides a basic knowledge of the business, but the more important objective is to motivate new employees to work for the goal of the company through harmony and teamwork. Spiritual attitudes such as pride, self-esteem, sense of duty, and responsibility for work and the company are emphasized. To promote these attitudes, some companies require new employees to stay in company dormitories for at least their first year. A retired ex-employee of the company is often the superintendent of the dormitory and he takes care of both the private and public life of new employees. Employees continue to take the stratified training program, lasting less than one week, every one or two years until they become middle-level personnel (about 10–15 years after recruitment).

Japanese companies also train new employees through frequent transfers from one section to another and from one branch office to another. This transfer policy provides the opportunity not only for new employees to be trained in different business activities under different supervisors, but also for the company management to observe the potential of young workers and decide where they are most suited to be assigned for the longer term. In large corporations new graduate employees continue to be transferred for 10–15 years.

Life-long employment

The existence of life-long employment and the resultant necessity to create a labor market within a company promote active training by Japanese companies. Although life-long employment is more prevalent in larger enterprises than in smaller ones, it is widely recognized that it is a unique characteristic of Japanese management and encourages companies to make a long-term investment in worker training. However, there is no legal basis for this system, binding either the employer or the employee. Lifelong employment has become customary. Employees stay in the same company for a variety of reasons. There is social pressure against change. Those who move to a different company are considered to be unstable and not highly competent (therefore they keep moving). Even if a worker wants to leave the company, it is difficult to find a new job since companies, especially large ones, recruit new graduates only once a year at a fixed time. Most employees prefer to stay because Japanese companies adopt a seniority wage system; and through company training over the years, employees develop a philosophy, attitude, specialized technical knowledge and skills unique to the company, and eventually loyalty to the company. Employers also have a vested interest in keeping their workers, because it allows them to make a long-term investment in personnel development; recruitment of workers from outside the company often causes friction between new and old employees and disturbs the harmony among employees; and traditional ethics exist among employers not to dismiss their workers easily. Thus, the cultural factors of employees' loy-

Vocational training institutions and training courses

	Basic training	Upgrading training	Redevelopment training	Instructor training
Vocational Training School (378)	■	■	■	
Junior Vocational Training College (6)	■			
Skill Development Center (2)		■	■	
Institute of Vocational Training (1)				■
Vocational Training School for the Handicapped (12)	■	■	■	

Note: Numbers of institutions are given in brackets.

The characteristics of four types of vocational training are summarized below:

Type of training	Objectives	Target group	Duration
Basic training	Provide basic skills and knowledge needed to become skilled workers	New graduates from lower and secondary schools	6 months to 3 years
Upgrading training	Help workers catch up with technological progress in industries	Workers who have basic skills and knowledge	10 hours to 6 months
Redevelopment training	Train workers who intend to find alternative jobs for which they are not trained	Adults employed or temporarily unemployed	2 months to one year
Instructor training	Provide necessary skills and knowledge to produce professional vocational training instructors		4 years

Source: K. Inoue, *The Education and Training of Industrial Manpower in Japan*, World Bank Staff Working Paper No 729, World Bank, 1985.

alty and employers' paternalism reinforce life-long employment in Japanese companies.

Because of life-long employment, management finds it difficult to recruit highly qualified and experienced personnel from the labor market outside the company. As a result they create a labor market inside the company through training. This internal labor market is often a closed system. Employees enter the market at the beginning of their careers and exit at retirement. However, labor within the system is not static, it is highly competitive and mobile. Employees compete for promotion. New employees in similar age groups and with similar academic qualifications have equal opportunities for promotion. They are often transferred among departments, and the company examines their merits and aptitudes. The most capable among professional and technical (white collar) workers become the president or executives of the company. Production (blue collar) workers also have an opportunity for promotion up to foremen. This internal promotion system, together with loyalty to a company, stimulates creativity and innovation in Japanese companies.

The existence of life-long employment and the creation of a labor market within a company also result in an approach to recruitment different from a typical Western model. In Western companies job responsibility and required qualifications are clearly defined. Anyone who meets the qualifications can apply for the job. Companies are interested in obtaining specific professional and technical knowledge and skills rather than a worker's general potential to become a productive and loyal member of the family called the company. When the position is no longer needed, the worker is often laid off. In contrast, Japanese companies recruit employees with a strong potential and train them to become dedicated company staff who meet the company's requirements. Job content and qualifications are therefore not clearly defined or emphasized in Japanese companies.

Worker participation

In addition to the interrelated practices of life-long employment, active worker training, and flexible labor movement within a company, Japanese industry mobilizes the best of its workforce by making employees participate in company decision-making processes. Worker participation provides management with a variety of suggestions to improve company operations and also raises the morale, especially self-esteem and pride, of workers, which helps increase productivity.

There are three main vehicles for worker participation: labor participation in management, a suggestion system, and a quality control system. Workers participate in management through activities such as collective bargaining, labor-management joint consultation, and profit sharing. The Japanese labor-management relationship is unique because more than 90 percent of unions are restricted to individual enterprises, which helps promote common interests among labor and management. After the first oil crisis, for example, unions accepted wage increases that were below the inflation rate. This compromise was possible mainly because of the unions' longer-term view and priority to employment security rather than wage increases. The suggestion system collects workers' opinions on their jobs and on the company in order to improve productivity and efficiency. It is estimated that about 75 percent of the establishments adopt the system and over 80 percent of workers in those establishments participate in it. According to a survey of 301 companies, the economic rate of return to the suggestion system was estimated to be as high as 29 percent.

Statistics-based quality control, originally brought in from the United States after World War II, has developed into a unique Japanese management system with several characteristics including company-wide quality control, small group activities called quality control circles, and training for quality control. A quality control circle is defined as a small group that operates spontaneously and continuously, as a part of company-wide quality control activities. It fosters self-development and mutual development, control and improvement of work within the workshop, and utilization of quality control techniques, with all members participating. Company-wide quality control affects all company activities relating not only to products but also to overall operations. Therefore, all departments of a company, including production, planning, sales, and personnel management, participate in the process. The number of quality control circles registered with the Japanese Union of Scientists and Engineers was only 23 in 1962 but increased rapidly to over 115,000 in 1980, with the participation of more than one million workers. If the participants of unregistered circles are counted, about one in five workers in all industries is estimated to be a member of a quality control circle. It is believed that workers participate in the circle not because of the direct economic benefit (most circles meet before or after working hours without payment), but because they can improve human relationships within plants and promote self-fulfillment. In short, the essence of the successful expansion of quality control circle activities is that imported techniques of quality control have been adjusted to the group-oriented cultural background of the Japanese management system.

Overview

As cautioned at the outset, the practices for personnel development and management in Japan are based on the Japanese social and cultural environment. It is therefore out of the question to suggest the wholesale transfer of the Japanese systems to a country with a different environment.

The roots of the Japanese manpower development and management systems lie in the traditional values and concepts of Japanese society. For example, the practices of life-long employment, seniority-based promotion, and consensus decision making are consistent with the underlying values of that society. These values are, however, changing among the younger workers who seem to place more importance on individualism and materialism and less on dedication and self-sacrifice. The system is beginning to adjust to those changes: some firms are recruiting mid-career workers from the labor market; salaries are gradually reflecting more emphasis on skills and job content and less on age.

While the practice of Japanese life-long employment is not simply transferable to other countries, the general lesson of the Japanese experience is that companies should attempt to move closer to this practice rather than move further away from it if they hope to create a sense of greater stability and harmony among workers. Among other useful lessons are the methods used to increase productivity and quality, in particular in production processes. Quality control techniques, for example, which Japan learned about from the West and improved upon, could be transferred to other countries. F&D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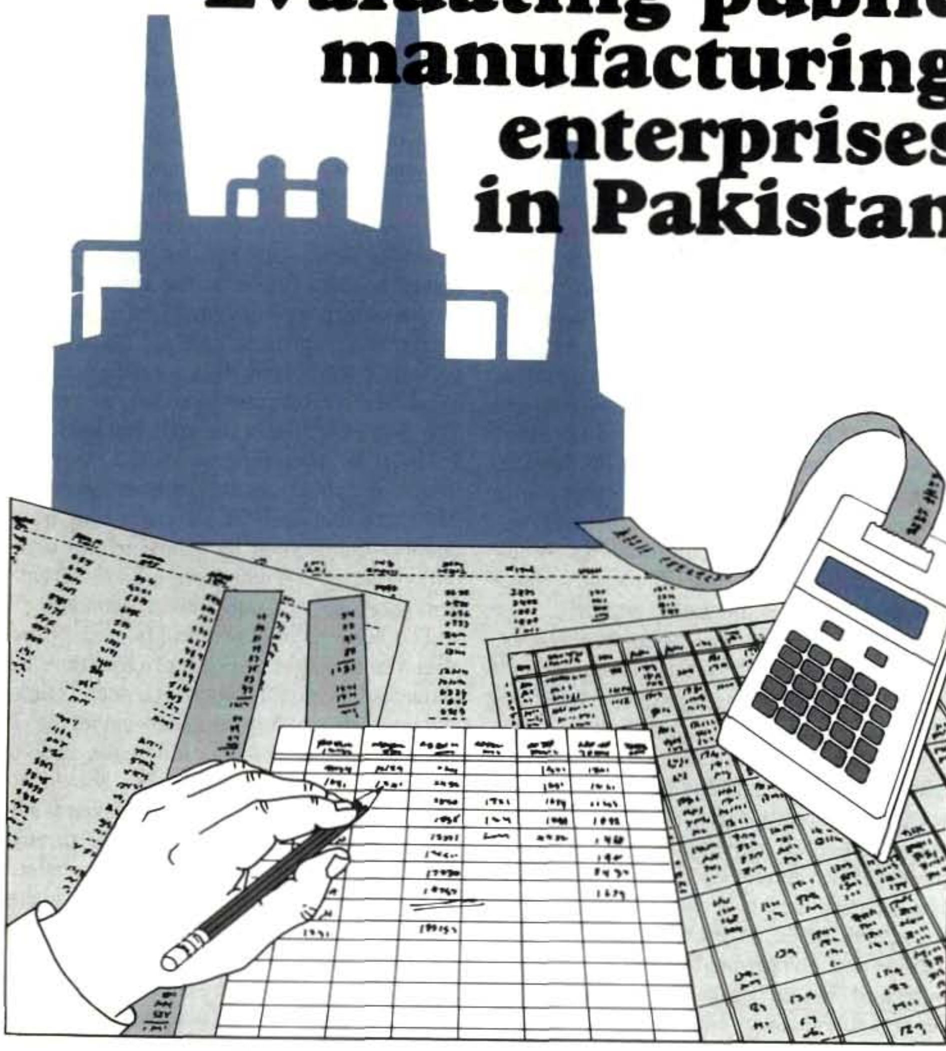
Evaluating public manufacturing enterprises in Pakistan



An experimental system of performance targets and related incentives for managers may serve as a model for other developing countries

Arntraud Hartmann and Syed Ali Nawab

In many developing countries public manufacturing enterprises contribute a large portion of industrial output and are the backbone of the industrialization process. According to the *World Development Report 1983*, in developing countries for which data are available, the contribution of state-owned enterprises to GDP in the 1970s increased from 7 to 10 percent. Public manufacturing enterprises also contribute substantially to investment. In developing countries, state-owned enterprises account for at least a quarter of capital formation. In some countries the share is much higher; for example, in Algeria, Burma, and Zambia, it is over 60 percent, while in Pakistan it is 45 percent.

Governments justify the creation and operation of state enterprises in many ways. Ideology, lack of a sufficiently strong private sector, and noncommercial objectives, all play a part in the decision to establish or sustain state enterprises. Noncommercial objectives are diverse and may cover employment generation and industrialization of underdeveloped regions, supply of products considered important to attain self-sufficiency of the country, maintenance of social peace through union contracts favorable to workers, support to other public firms through procurement of inputs at noncompetitive prices, and national security (in the case of defense-related enterprises). However, the performance of public enterprises in developing countries has often been disappointing, and public firms are generally judged to be less efficient than their counterparts in the private sector. As a result, governments often have to pay large subsidies to cover operating losses of public enterprises.

The unsatisfactory performance may result from high production costs because of noncommercial objectives pursued by public enterprises, price controls on inputs and outputs, poor financial structures of the firm, and unsuitable location of these enterprises. In many cases, it is also the result of poor management that continues to employ unsuitable production patterns and outdated technology, and results in low labor productivity and poor marketing. Managers of public firms often lack adequate experience in the management of commercially viable units, and appointments are frequently based on political considerations. They are also usually hampered by a tight network of government controls that regulates all types of managerial decisions and does not foster risk taking and innovation. Public managers also frequently lack clear objectives and do not receive incentives for improved performance. They are seldom rewarded for the good performance or penalized for the poor performance of their enterprises.

To monitor performance and provide incentives for improved management of its public sector, Pakistan introduced a "signaling system" for most of its public manufacturing firms in 1983. The system provides for clear quantifiable performance targets for each enterprise, and managers are evaluated and receive bonus payments according to these. To date it has only been implemented for manufacturing firms, but extension of a modified system to other public companies, such as utilities and transportation corporations, is being considered. The fact that the system links substantial bonus payments to quantifiable targets makes it an interesting and innovative attempt. While several developing countries are currently trying to establish similar systems, the experiment in Pakistan probably presents the most advanced and boldest approach. It has so far been well received by public managers within the country, and the interest expressed by other developing countries indicates that it may well serve as a model for evaluating the performance of public enterprises in other countries.

Public manufacturing in Pakistan

The public manufacturing sector in Pakistan remains relatively small but quite important.

It accounts for only about 15 percent of industrial output but dominates a number of key industries: fertilizers, cement, engineering, steel, petroleum refining and chemicals, automotive assembly and manufacture of parts, and vegetable ghee (cooking oil). These industries supply a large number of other enterprises in the private sector with inputs, thus affecting the quality, level, and prices of other products in the economy at large. The existing public manufacturing sector reflects the industrialization policy pursued by the Government in control during 1971–77 that assigned the public sector the leading role in industrial development. That Government established a number of large public industries. The succeeding administration reversed that policy. It denationalized smaller agro-industrial units, provided legal guarantees against further nationalization, and announced that it expected the private sector to spearhead industrial development. The public manufacturing sector would be limited to its present size and would receive no government budget allocation for new investments. Further, public firms would be expected to act more like their counterparts in the private sector. Currently, there is a strong emphasis on commercial objectives, and public units are expected to become financially viable and to maximize profits.

The majority of Pakistan's public manufacturing firms come under the Ministry of Production through nine holding corporations. The Ministry sets guidelines and coordinates policies for most of the public manufacturing sector. Each holding corporation supervises 1 to 13 units from the same subsector, for example, the National Fertilizer Corporation oversees all public fertilizer plants, the State Cement Corporation all cement units, and the State Engineering Corporation all engineering units. Holding corporations plan and monitor financial performance, production targets, and investments, and approve many of the day-to-day decisions of public managers.

To enable the public units to become more efficient and dynamic, the Ministry has initiated a number of structural reforms. These include increased delegation to the holding corporations of decision-making authority on operational matters and the introduction of an improved salary structure that provides appropriate differentiation of salaries by levels of skill and responsibility. These measures have already led to improved performance by public units, particularly in productivity. However, profitability in many units remains low. Poor operations are not only the result of inadequate management but also of pricing regulations that provide for guaranteed rates of return in selected sectors (including cement, fertilizers, petroleum products, vegetable ghee). Pricing arrangements differ from sector to sector but generally provide insufficient incentives for reduction of costs, reinvestment of funds, or maximization of profits.

Signaling system

The conglomeration of targets and incentives that guide managers is called the signaling system. In Pakistan the system consists of three major components: a management information system; a performance evaluation system; and a bonus salary system. The system was designed by Professor Leroy Jones of Boston University for the Government of Pakistan and prepared over a three-year period by a consulting firm in cooperation with the implementing agency, the Experts Advisory Cell (EAC), a small autonomous organization under the Ministry of Production. The World Bank financed the preparation of the signaling system under a technical assistance credit from the International Development Association, and Bank staff have monitored its implementation closely.

Information system. A comprehensive, reliable, and timely information system is a precondition for an effective performance evaluation system. The establishment of such a system and the creation of computerized information on each of the public enterprises was, therefore, the first step to be carried out in the implementation of the signaling project. Each month information on production, manufacturing costs, salaries, profits, taxes and duties, inventories, capacity utilization, and employment is fed into a computerized file on the basis of standardized reports submitted by each unit. The Ministry of Production has direct access to this information.

The task of establishing the system turned out to be more challenging than anticipated. Operational data, financial statements, and the terminology employed differed widely from unit to unit. This made intercompany comparisons very difficult. To standardize information, the EAC designed an accounting manual that introduced uniform cost-accounting systems as well as standard terminology. The EAC publishes monthly, quarterly, and annual reports that include full financial information for every enterprise, complemented by a number of economic variables such as value added, labor productivity, revenues, and price changes. Monthly performance reports for each enterprise are also available to the holding corporations and the Ministry of Production so that they can monitor progress on a continuous basis and detect possible problems early.

Performance evaluation. The performance evaluation system consists of the negotiation of annual targets for each enterprise before the beginning of each fiscal year and the evaluation of results at the end of the year. Setting appropriate performance targets for public enterprises is a difficult and important task. Targets guide managers in their decisions and focus their efforts toward achievement of the stated goals. In the long run, therefore, targets direct a firm on the right or the wrong development path. Performance targets for public and private firms need to be defined differently. In the long run, the objectives of a private firm are to maximize profits and returns only to private equity holders. Since in the case of state-owned enterprises the government owns the equity and represents all groups within a society, public enterprises should attempt to increase the returns to the society as a whole. The final objective of the signaling system in Pakistan is, therefore, to define targets in terms of "public profits" that measure the difference between social costs and social benefits contributed by a firm to the economy—that is, the difference between what a firm takes out and puts into an economy.

The concept of public profits uses private after-tax profit as a point of departure but eliminates all transfer payments, such as taxes and subsidies, since transfer payments as such do not increase or decrease national welfare and the public manager should not try to maximize subsidies or minimize taxes. Then, private profits are adjusted through the so-called "social adjustment account." This is primarily used to quantify higher production costs incurred by the public enterprises in pursuing noncommercial objectives, such as high transportation costs because of operations in backward areas, high wages because of social considerations, or high labor costs because of overstaffing for employment creation. Assuming that these higher production costs, in fact, lead to comparable social benefits, they are added to the profits. The social adjustment account is also used to make corrections for major distortions of input or output prices.

A further feature of the public profit indicator in Pakistan is that it has been defined as a single-period indicator (limited to one year for now). Unlike calculations of private profit, neither depreciation nor financial charges for other than working capital are entered as a cost. The single-period indicator was chosen since public managers in Pakistan generally cannot influence financial structures or the capital endowment of their units but are expected to maximize profits within these given parameters. Taking this observation one step further, it was also decided to use "public profitability" instead of public profit as the final indicator of performance in later stages of the signaling system. Public profitability, defined as the ratio of public profit to operating assets, relates profits to the amount of capital available in a plant. It,

therefore, allows comparisons between different firms in the same sector that often operate with very different capital structures and therefore achieve different profit levels. The Government was reluctant to introduce "public profits" or "public profitability" as an indicator in the initial stages of the program.

Chart 1

Public profit = Private profit (after tax)
+ Direct taxes
+ Interest payments
− Financial incomes
+ Depreciation
− Opportunity cost of working capital
− Subsidies
± Adjustments (social adjustment account)

$$\text{Public profitability} = \frac{\text{Public profit}}{\text{Operating fixed assets}}$$

Chart 2

NAME OF UNIT ....

Following targets are agreed for the year ....

Criteria	Weights	A	B	C	D	E
Profitability						
Physical Production						
Productivity						
Energy Consumption						
Others						

It is agreed that net profit shall not be less than Rs. ________ million in any case.
Profitability during previous year was ________.

ad/-
CHIEF EXECUTIVE
____

ad/-
EXPERTS ADVISORY CELL
____

Dated ________________

Chart 3
Performance evaluation system
— An example —

CRITERION	WEIGHT	IMPROVEMENT TARGETS (In percent)				
		HIGH 1	2	3	4	5
Private Profitability	0.60	40	35	30	25	20
Physical Production	0.20	35	30	25	15	5
Productivity	0.15	30	25	20	15	10
Energy Consumption	0.05	50	40	30	20	10

CRITERION	WEIGHT	ACHIEVEMENT	ITEM SCORE	
			RAW	WEIGHTED
Private Profitability	0.60	25%	4	2.40
Physical Production	0.20	30%	2	0.40
Productivity	0.15	25%	2	0.30
Energy Consumption	0.05	50%	1	0.05
			TOTAL	3.15

GRADE ACHIEVED = C

Grades:	Range of Weighted Scores
A =	1.00 – 1.95
B =	1.96 – 2.45
C =	2.46 – 3.45
D =	3.46 – 4.45
E =	4.46 – 5.00

It was concerned that enterprises that improved performance according to public profitability, but still ran financial losses, would require subsidies from government budgets to cover their bonuses. The Government also was concerned that bonus payments for managers of financially nonviable firms would lead to demands for bonus payments from workers, who, under union contracts, normally would receive such payments only if their firms made commercial profits.

The system adopted to measure performance used private profitability as a criterion in the first year, but added to it other indicators in the second year (see Chart 1). For most units the performance criterion consists of a weighted average of private profitability, physical production, productivity, and energy consumption. Weights attached to each indicator differ from firm to firm, depending on the relative importance of each indicator for each firm. In most cases, private profitability receives the maximum weight. The only exception to this are firms that are guaranteed

fixed rates of return under the government's regulated pricing system. In those cases, private profitability becomes a meaningless concept and is replaced by other indicators. Depending on the nature of the pricing arrangements, private profitability is substituted by partial indicators such as productivity, production of selected higher value-added products, capacity utilization, variable costs, or energy consumption. Finally, specific target values are assigned to each weighted indicator with corresponding grades for full or partial achievement of these values.

The annual targets for a fiscal year are set in the fourth quarter of the preceding fiscal year. This involves complex and lengthy negotiations between the individual firms and the EAC during which agreement is reached on indicators, weights, and targets. Targets are based on the budgetary proposals prepared by the enterprise and additional considerations, such as past performance of the enterprise, achievements of similar firms in the private sector or in other developing countries, specific financial and physical constraints expected for the enterprise during the next fiscal year, and possible effects of macropolicies on inputs and outputs of the enterprise. In defining the target values, the EAC attempts to avoid adversely affecting the cash flow position of a firm because of bonus payments. The target negotiation process culminates in the signing of a contract between the EAC and each participating enterprise (see sample, Chart 2).

Bonus system. With a comprehensive information system and agreed targets in place, evaluation of achievements and payments of bonuses are an automatic process. Bonuses amounting to three months' salary are paid to managers of firms that receive grade A, two months for grade B, one month for grade C, half a month's salary for grade D, and none for grade E. Chart 3 illustrates the hypothetical grading of one enterprise and the weighted score corresponding to each grade. Bonuses are paid to all employees in managerial grades in a unit but not to workers who currently are eligible for bonus payments under union contracts. The distribution of bonus payments to the individual employees in the management group is left to the discretion of the managing director of each enterprise.

Implementation

In fiscal year 1983/84, 41 out of the 61 units that were then under the Ministry of Production participated under the system, of which 11 units achieved grade A; 5 units grade B; 9 units grade C; 1 unit grade D; and 15 units grade E. Operating results were generally comparable to previous years. Given the novelty of the system in this first implementation cycle it was not expected that operating results would be greatly influenced by the targets of the signaling system, particularly since targets were negotiated very late in the fiscal year, leaving managers little time to adjust their decisions to the new system.

The implementation of the system has proceeded very smoothly and the innovation has been welcomed by public managers. Implementation has greatly benefited from the fact that it rests in the hands of a small government agency outside the direct chain of command of the ministries. The EAC operates as a monitoring, evaluation, and consulting organization to all public manufacturing enterprises under the Ministry of Production and is fully financed by the public corporations. Staff of the institution are specially recruited and are not part of the civil service with its frequently rotating assignments, and they receive relatively attractive salaries. The organization has also benefited from the authority of the Ministry of Production, under which it operates, in getting assistance from other government bodies and the cooperation of the firms being monitored. This has been a vital factor in the success of the unit in collecting timely data for the monitoring system and in implementing the evaluation program.

The establishment of the information and monitoring system has already brought about a major improvement in the timeliness and availability of information on the operations of public enterprises. This enables the Ministry of Production to meet regularly with the staff of holding corporations and to review the performance of the enterprises. The systematic and timely collection and evaluation of data for this system should, over time, replace many of the routine reporting requirements to ministries and holding corporations that currently occupy much of the public managers' time.

Michele Iannacci for F&D

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Much of the system's success will depend on whether it defines the right targets and whether these targets encourage managers to alter their managerial behavior. This process of target definition remains the most challenging hurdle. The present procedure of having a number of partial indicators, including private profitability, is an acceptable interim solution. In the long run a more standardized and consistent criterion needs to be applied that takes better account of the noncommercial objectives of public units and makes some necessary accounting adjustments between public and private profits. The introduction of a public profitability criterion will, of necessity, need to be a gradual process, since the economic concepts behind such a criterion are complex and need to be carefully explained to, and understood by, the affected managers.

Appropriate targets also need to be defined as part of a longer-term plan prepared for each firm. Targets are currently only defined as single period indicators that do not take into consideration the medium- or long-term development plans of enterprises. The EAC recognizes this and intends to strengthen the currently very weak corporate planning efforts of public firms with a corporate planning and assistance program. This would help each firm to prepare a detailed corporate strategy and plan, which, after evaluation by the EAC, would provide the framework for the definition of targets for each enterprise.

Improvements in public sector efficiency not only depend on a better directed management but also require a better managerial environment with greater decision-making authority delegated to the individual manager, and a rationalized incentive system and pricing policies. While the signaling system, itself, does not provide for any changes in the regulatory environment, it can set the stage for further deregulation and reformulation of policies. By providing for clearly defined targets and judging managers by results, the need for a system to control operating decisions is reduced. By requiring public managers to adopt longer time horizons through detailed corporate plans, contractual arrangements between individual enterprises and the Government could be made, similar to the *contrat plan* system established for public enterprises in France and in some countries in West Africa. These contracts could provide for a more predictable and rationalized external environment and incentive structure for the individual enterprise.

Lomé III: the search for greater effectiveness

While the new Convention retains the principles of the original Lomé agreement, and maintains financing in real terms, it also reflects changing perceptions of how to promote economic growth

Michael Blackwell

The Lomé Convention unites the European Community and a group of African, Caribbean, and Pacific (ACP) states in an agreement which includes among its most notable features trade preferences, aid, and special facilities. When it first entered into effect in 1975, it was heralded as the only agreement that brought industrial countries and developing countries together as equal partners in mutual recognition of their interdependence in seeking economic growth and development, and as a step forward in the construction of a New International Economic Order.

Over the years some of the initial optimism has dissipated; indeed, some ACP spokesmen have claimed that the two sides now relate to each other more as aid donors and recipients than as equal partners. Although acknowledging that many ACP states have not derived all of the economic benefits they had hoped for, the European Community has argued that the Convention grants these states greater access to Community markets and the greater share of EC aid flows. In the Community's view, the ideal of partnership has not been abandoned and the failure of many ACP states to derive greater benefits from the Convention is best explained by the inappropriate policy stances adopted by their governments.

The 1983–84 negotiations for the third Lomé Convention were rooted in these contrasting perspectives and often echoed the broader debates that practitioners and scholars alike have lately engaged in on the effectiveness of aid, the respective merits of competitiveness and appropriate domestic policies versus trade preferences in stimulating export growth, and the role of special facilities in helping countries adjust to fluctuating demand for their commodities. This article examines the issues raised and the agreements reached in the course of negotiating the Lomé III Convention and pays particular attention to the changes in its language and emphasis.

Background

Lomé has as its origin the European Community's decision in 1957 to set up a European Development Fund (EDF) worth $581 million—quite separate from the general Community budget and from members' bilateral aid budgets—to be used over a five-year period to make development grants to their predominantly African overseas countries and territories. By 1963 many of these had become independent and a more formal agreement, the First Yaoundé Convention, was concluded to specify the nature of trade preferences and development assistance that the Community was prepared to offer its partners. When the United Kingdom formally achieved EC membership in 1973, some of the developing countries of the Commonwealth decided they would join with the Yaoundé Convention participants and some other African countries to form a group of African, Caribbean, and Pacific States that would approach the Community as a common negotiating body and seek a new, wider Convention. The ensuing negotiations resulted in a five-year Convention, which was signed at Lomé, Togo, in 1975 and has subsequently been renewed twice. Lomé III has a financial endowment of ECU 8.5 billion (in June 1985, one ECU or European Currency Unit was worth about $0.73), compared with ECU 5.5 billion under Lomé II and ECU 3.5 billion under Lomé I. The number of signatory ACP countries has risen from 46 in Lomé I to 66 in Lomé III.

Although all three Conventions have contained a wide variety of provisions, ranging from assistance with agricultural development to cultural cooperation, their major features have centered around joint management of trade preferences, aid provisions, and special facilities, namely, STABEX (the system for the stabilization of export earnings) and SYSMIN (a special facility for mining products).

Participants in the Lomé Convention are:

European Community: Belgium, Denmark, France, the Federal Republic of Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, and the United Kingdom. Portugal and Spain are expected to become participants in 1986.

ACP states: Angola, Antigua and Barbuda, the Bahamas, Barbados, Belize, Benin, Botswana, Burkina Faso, Burundi, Cameroon, Cape Verde, the Central African Republic, Chad, the Comoros, the Congo, Djibouti, Dominica, Equatorial Guinea, Ethiopia, Fiji, Gabon, The Gambia, Ghana, Grenada, Guinea, Guinea Bissau, Guyana, the Ivory Coast, Jamaica, Kenya, Kiribati, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Mauritius, the People's Republic of Mozambique, Niger, Nigeria, Papua New Guinea, Rwanda, St. Christopher and Nevis, St. Lucia, St. Vincent, São Tomé and Principe, Senegal, Seychelles, Sierra Leone, Solomon Islands, Somalia, Sudan, Suriname, Swaziland, Tanzania, Togo, Tonga, Trinidad and Tobago, Tuvalu, Uganda, Vanuatu, Western Samoa, Zaïre, Zambia, and Zimbabwe.

The Lomé III agreement effected changes in each of these areas.

Trade provisions

The drafters of the first Lomé Convention were convinced that the extension of trade preferences to the ACP countries would boost their export capacity and hence encourage economic growth and development. Looked at purely in terms of EC-ACP trading relations, this objective does not seem to have been achieved. Although ACP exports to the Community, excluding crude and refined petroleum products, have increased in value by 51 percent between 1976 and 1983, their share of total EC imports from outside the Community during this period fell from 6.3 percent to 4.5 percent, while their share of imports into the EC from all developing countries remained stable at around 19 percent. During the same period the trade balance in the Community's favor rose from ECU 3.5 billion to ECU 4.4 billion. However, it is not possible to draw definite conclusions from these figures about the effects of the Lomé Convention on trade. For example, they mask the fact that some individual ACP states have considerably increased and diversified their exports to EC markets. The Community view is that these figures- taken in conjunction with the evidence that many ACP states have limited themselves to traditional exports, have failed to match the productivity and quality advances of Asian and Latin American competitors, and have seen a consequent decline in their exports—suggest that the full benefits of trade preferences can only be enjoyed by countries with domestic policies that encourage a dynamic and flexible productive sector.

The ACP states, while not totally rejecting this analysis, argue that some elements of the Convention, in fact, hinder the growth of their exports. They claim, for example, that the Convention's safeguard clause tends to inhibit growth in areas where they could enjoy the greatest dynamic comparative advantage and provides a powerful disincentive to their industrial development. The Community has pointed out that it has never invoked the safeguard clause and has only asked one ACP country—Mauritius—to accept a voluntary export restraint agreement (for textiles). It feels there is room for increased exports of even sensitive products and that the specter of the safeguard clause is used rather unfairly to excuse weakness in the ACP countries' productive capacity.

The ACP countries advance similar arguments with regard to the rules of origin. In their view more lenient rules of origin would encourage greater external investment. The Community's response is that the rules of origin of the Lomé Convention are considerably more generous and flexible than those applied by the Generalized System of Preferences. The Community notes that very few countries have taken advantage of the exceptions that are offered and it is concerned that any further liberalization would probably serve only to open a back door to its markets for its industrial country competitors, while bringing few real economic benefits to the ACP countries themselves.

Several ACP states argue that they could rapidly increase their exports to the Community if the freedom of access granted to manufactured goods applied also to agricultural products covered by the EC Common Agricultural Policy. Special arrangements are provided for beef, rice, sugar, rum, and bananas, which are of great value for a few ACP countries; on the whole, however, access for agricultural products is no more generous than that offered to countries outside the Convention. The Community has made a few minor concessions on agricultural trade in the Lomé III Convention—mainly designed to broaden and speed up consideration of requests for preferential access—but holds out little hope of any major liberalization in this area.

In short, the Community believes that ACP countries are unlikely to increase their exports unless they take action themselves to boost their productive capacity and improve their competitiveness. For this reason, the new Convention offers greater possibilities for the financing of measures to help individual ACP states develop coherent trade strategies; train personnel in export-related jobs; enhance the quality of products, particularly by adapting them to market requirements; and improve infrastructure, notably for transport and storage facilities.

Aid

Under each Lomé Convention the financial endowment of the EDF is divided between the special facilities, regional aid programs, and individual country programs. For the latter category the Commission draws up an indicative program with each ACP country and earmarks specific resources according mainly to the country's population and GDP per capita.

The effectiveness of aid granted under the Lomé Convention has come under close scrutiny in recent years, most notably in the "Pisani memorandum" prepared in 1982 by the Commissioner then in charge of development affairs, Edgard Pisani. In the Lomé III negotiations, both sides recognized that much aid granted under previous Lomé Conventions had been used inefficiently, with only a limited impact on development. The ACP states faulted delays in the selection and financing of development projects and cited an overcentralized decision-making process in Brussels and cumbersome bureaucratic procedures. To the Community the problem was more fundamental. Its evaluation of the effectiveness of Lomé aid led to the conclusion that efficiency was less related to the quality of the goods or services provided than to the degree to which local skills and initiative were stimulated. Pisani went so far as to say that "below a certain threshold of effectiveness and relevance, aid becomes an evil, for it nourishes illusions and encourages passivity." In this light, it seemed imperative that new Lomé resources should be used less for new capital projects and more for integrated sectoral programs, particularly with a view to agricultural and rural development.

To achieve this shift in emphasis the Community negotiators asked their ACP counterparts to accept a "policy dialogue," which would precede the choice of schemes to be financed from Lomé resources. Initially, many ACP states took grave exception to this term, believing it to be a euphemism for EC control of their development plans and thus an encroachment on their national sovereignty and incompatible with the principle of equal partnership. In the end no direct reference was made to policy dialogue in the new Convention and spokesmen for both sides were at some pains to emphasize that the ACP states retained their contractual right to choose the way in which aid would be used. However, the ACP states agreed to include in the first chapter of the Convention a statement to the effect that "support shall be provided in ACP-EEC cooperation for the ACP states' own efforts to achieve more self-reliant and self-sustained development" and to reach this objective "special efforts shall be made . . . to promote rural development, food security for the people and the revival and strengthening of agricultural production potential in the ACP states." The Community hopes that this language and the new emphasis on programs, sectoral development, and the stimulation of national potential that it implies will lead to a much more detailed consideration of a country's overall objectives and, hence, automatically, to a more thorough dialogue on the policies needed to achieve them. It remains to be seen, however, whether the Community and the individual ACP states will in reality be able to come to a more united appreciation of the optimal way in which the Convention's resources can be used.

STABEX

A major part of the debate on aid efficiency was focused on the utilization of STABEX resources. STABEX is probably the most distinctive feature of the Lomé Convention. It grew out of the Community's recognition

in the early 1970s that aid tended to be less effective in countries experiencing instability in their export revenues. STABEX was introduced in the first Lomé Convention as a means of alleviating this problem and now compensates ACP states for loss of export earnings from any of a list of 48 agricultural products and subproducts.

Although there is a certain amount of overlap between STABEX and the IMF's compensatory financing facility, there are many differences, two of the most notable being that (1) STABEX takes no account of earnings from other merchandise exports or of the country's overall balance of payments position in calculating the compensation for a shortfall in earnings from one of the covered commodities (in other words, a country can draw from STABEX even if there is an upward trend in its overall export earnings) and (2) drawings are not limited by any equivalent of the member's quota in the Fund, but by the resources the Community allocates to the scheme for a particular period. Given the limited number of commodities covered, these features of STABEX have led to situations in which a relatively high proportion of the available resources has been directed to a small number of countries.

STABEX worked fairly smoothly during its initial period of operation, 1975–79. The ECU 382 million set aside to finance it met all the eligible claims. Despite an increase in its resources to ECU 557 million, however, the scheme ran into serious difficulties at the beginning of the Lomé II period, as the prices of several commodities dropped rapidly in comparison with the average prices of the reference period. In both 1980 and 1981, claims of up to ECU 1 million were met in full, but transfers to meet larger claims had to be reduced by about one half. The system regained its equilibrium in 1982 and 1983 as the high commodity price years of the late 1970s dropped out of the reference period.

In preparing for the Lomé III negotiations, the European Community, while acknowledging that many STABEX claims could be attributed to reasons beyond a claiming country's control, such as adverse market or climatic conditions, argued that many others could be explained by falling levels of production and competitiveness. This situation, it believed, was often brought about by the low priority some governments had given to agriculture, notably by policies that set producer prices too low, and by inefficient transportation and other infrastructural problems. The Community felt that several ACP countries had failed to use STABEX resources to tackle these problems, employing these funds instead to meet the most pressing demands on the national budget on the frequently tenuous grounds that this represented a permitted diversification away from the troubled export sector. After long discussions of principle on how free the claiming country's authorities should be to decide the best use to which STABEX payments could be put, it was agreed that financing diversification measures would be permissible; however, the Community obtained the insertion of

Major provisions of the Lomé III Convention

Trade

• Free access to EC market for all manufactured products where materials originate in the ACP states or in the Community.

• Free access for manufactured products containing materials from other sources if, among others, (1) nonoriginating materials account for less than 5 percent of total material costs, and (2) certain types of processing of the nonoriginating materials have been carried out.

• Exception to the rules of origin granted, inter alia, when nonoriginating materials represent at least 60 percent of value of finished product or when these materials originate in UN-designated least developed countries.

• Conditions of access for all agricultural products sometimes more preferential, never less so, than those offered to third countries.

• Community can take safeguard measures if trade provisions result in serious disturbances in economic sector of a member state or jeopardize external financial stability.

• Financial and technical assistance provided to assist development of ACP trade potential.

Aid

STABEX

• Provides compensation for a loss of earnings from exports to the Community and, in some cases, to the rest of the world, if: (1) the product(s) represented at least 6 percent of the claiming country's total exports during claim year (1.5 percent for landlocked, island, and least developed countries); and (2) earnings from product fell at least 6 percent during claim year (1.5 percent for landlocked, island, and least developed countries) compared to earnings during a reference period (generally the preceding four years).

• All claims considered simultaneously in year following claim year.

• Transfers repayable if earnings increase sufficiently during seven-year period following claim year (no such obligation for landlocked, island, and least developed countries).

SYSMIN

• Provides assistance to help overcome adverse consequences of a fall in ability to produce or export copper (and associated cobalt), phosphates, manganese, bauxite (and alumina), tin, or iron ore.

• Country eligible if at least 15 percent of total export earnings derived from a covered mineral (10 percent for the landlocked, island, and least developed countries).

• Country can be eligible, by exemption, if 20 percent (12 percent for landlocked, island, and least developed countries) of total export earnings derived from any combination of mining products other than precious minerals, oil, and gas.

Financial endowment for 1985–89

Grants to individual ACP states	ECU 4,360 million
Emergency aid	210 million
Aid for refugees	80 million
Interest rate subsidies for European Investment Bank loans	210 million
STABEX	925 million
SYSMIN	415 million
Special loans	600 million
Risk capital	600 million
Loans from EIB	1,100 million
Total	**8,500 million**

language that "Every request for a transfer shall, in addition to the necessary statistical data, include substantial information on the loss of earnings and also the programmes and operations to which the ACP state has allocated or undertakes to allocate the funds." This is much stronger than the corresponding Lomé II text, which provided only that the ACP state should give the Community "some indication of the probable use to which the transfer will be put." In addition, the new Convention permits the Community to suspend decisions on subsequent claims if a satisfactory account of the transfer has not been rendered one year after the transfer decision was made. These two new provisions should help the Community to ensure that the use of STABEX funds is directly related to the reasons for the shortfall in export earnings concerned.

SYSMIN

Increasing the efficiency of aid and promoting the productive use of special facility resources were also at the heart of negotiations concerning SYSMIN. SYSMIN was introduced with the Lomé II Convention and came into effect in 1980. It was designed to help ACP countries cope with any serious temporary problems beyond their control which caused, or were projected to cause, a decline in their capacity to export certain specified minerals. Unlike STABEX, SYSMIN was not designed to compensate for a decline in export earnings. Its resources were expected to be used primarily to help maintain production capacity during adverse market conditions and their release was made conditional upon Commission examination and approval. The Community was careful to avoid any element of automaticity, so that multinational mining companies could not organize their activities with the express purpose of becoming eligible for transfers.

In its first four years of operation SYSMIN benefited only four countries—Guyana, Rwanda, Zaïre, and Zambia. During the negotiations for Lomé III, a number of the ACP countries complained about this and noted that under Lomé II only some 12 countries were potential beneficiaries of the system. The Community agreed to go some way toward meeting these concerns. While it was unwilling to change the list of covered minerals, it did agree to open a "second window" to SYSMIN resources. This provided exceptions, on a case-by-case basis, for ACP countries deriving 20 percent of their export earnings (12 percent for the landlocked, island, and least-developed countries) from a combination of mining products other than precious minerals, oil, and gas, but not necessarily those mentioned specifically in the Convention. The opening of this "second window" to SYSMIN resources is expected to benefit a number of ACP states, notably, Botswana, Niger, and Zimbabwe.

The Community also liberalized the detailed criteria for the eligibility of claims by agreeing to consider using SYSMIN funds to remedy problems caused for major development projects, when the financing from the mineral sector on which they depend is seriously cut back or terminated, and also made more explicit that SYSMIN funds can be used to deal with structural as well as cyclical problems. Under the new Convention, the system can be used not only following "accidents" or "grave political events" but also in cases of adverse technological developments (such as the substitution of plastics for copper in traditional copper uses) or adverse economic developments (such as the inflationary impact of an oil price increase on mining operations).

Perhaps the most important change in the provisions for SYSMIN in the Lomé III Convention is in its orientation. Under Lomé II the main purpose of interventions was to maintain production capacity during a difficult period. Under the new convention the aim will be "to reestablish the viability" of the mining sector concerned. This will allow the Community not only to finance improvements to the production infrastructure but also, when it is considered to be in the best interests of the ACP country concerned, to finance orderly reductions in production capacity.

Conclusion

Although some signatories of the Lomé Convention feel that it falls short of what was originally hoped for, all are agreed that its overall effects have been beneficial. There is considerable satisfaction on the ACP side that the real value of the Convention has been maintained at a time when several Community members have been actively considering cuts in aid budgets and when the real value of some other multilateral funds, such as IDA, has been reduced. There is also satisfaction that the latest Lomé Convention offers some new benefits to the ACP countries and promises a new flexibility and a streamlining of administrative procedures. On the Community side there is hope that the new Convention will be more effective in promoting economic development and that through its institutions it will continue to provide one of the most significant forums for the North-South dialogue. F&D

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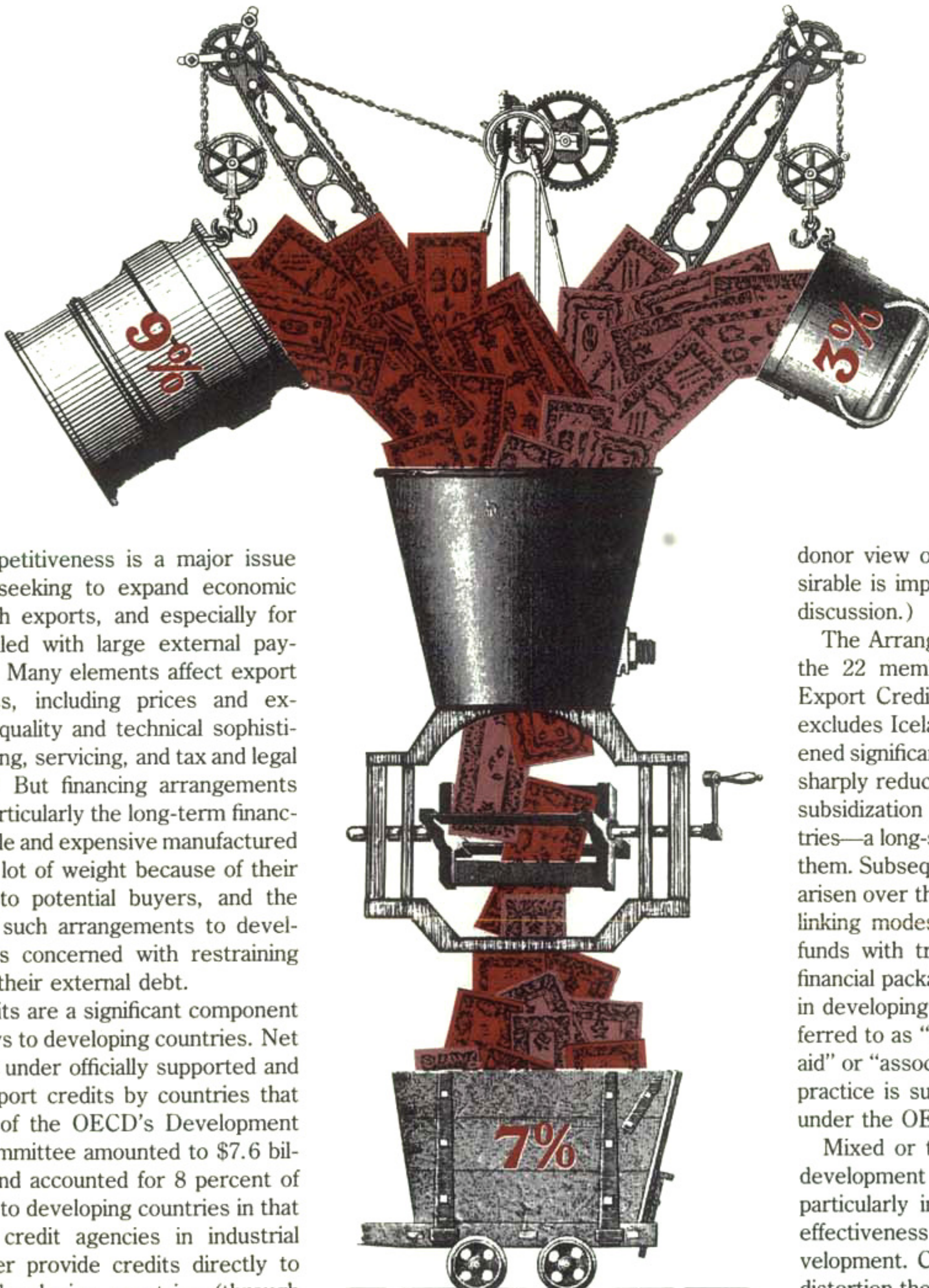
The OECD export credits agreement

Recent developments, and a review of efforts to curb mixed credits

David M. Cheney



Export competitiveness is a major issue for countries seeking to expand economic activity through exports, and especially for countries saddled with large external payments deficits. Many elements affect export competitiveness, including prices and exchange rates, quality and technical sophistication, marketing, servicing, and tax and legal considerations. But financing arrangements for exports, particularly the long-term financing of large-scale and expensive manufactured items, carry a lot of weight because of their high visibility to potential buyers, and the importance of such arrangements to developing countries concerned with restraining the growth of their external debt.

Export credits are a significant component of financial flows to developing countries. Net disbursements under officially supported and guaranteed export credits by countries that are members of the OECD's Development Assistance Committee amounted to $7.6 billion in 1983, and accounted for 8 percent of the total flows to developing countries in that year. Export credit agencies in industrial countries either provide credits directly to importers in developing countries (through such mechanisms as direct credits, refinancings of commercial credits, and interest rate subsidies) or guarantee commercial bank or supplier credits. Agencies that provide direct financial support try to maximize the competitiveness of their longer-term export financing within the limits prescribed by prudent risk analysis and by several international accords. Foremost among these accords is the Arrangement on Guidelines for Officially Supported Export Credits, established in 1978 under the auspices of the Organization for Economic Cooperation and Development. The Arrangement sets minimum allowable interest rates, minimum required cash downpayments, and maximum repayment terms on officially supported credits of two years and over; these are designed to limit competitive subsidization of export financing by OECD governments, so that exports compete on the basis of nonfinancing elements. (The donor view of subsidized financing as undesirable is implicitly accepted in the following discussion.)

The Arrangement, which is adhered to by the 22 members of the OECD Group on Export Credits and Credit Guarantees (and excludes Iceland and Turkey), was strengthened significantly in 1983. The new provisions sharply reduced the scope for export finance subsidization by the major industrial countries—a long-standing source of friction among them. Subsequently, however, contention has arisen over the growing practice of mixing or linking modest amounts of concessional aid funds with traditional export finance in the financial packages offered to potential buyers in developing countries—these packages referred to as "mixed" credits, a form of "tied-aid" or "associated financing" (see box). This practice is subject to only limited regulation under the OECD Arrangement.

Mixed or tied-aid credits have an explicit development aid component, and provoke particularly important questions about their effectiveness and efficiency in financing development. Critics of tied-aid credits cite the distortion they create in both trade flows and development assistance by diverting scarce foreign aid funds meant for poorer countries to support commercial export sales, typically in the more advanced developing countries. Advocates, however, contend that tied-aid credits reduce the cost to developing countries of projects with a high developmental content, and stretch the development impact of scarce foreign aid funds. Proponents also argue that such credits enable poor countries to attain access to needed imports, particu-

larly when commercial flows to them have been reduced.

The Arrangement circumscribes the level of export credit subsidy by limiting repayment terms and setting a floor for fixed interest rates on medium- and long-term government-supported export credits with a maturity of two years or longer. Its adherents have also been concerned with improving "transparency and discipline" in the extension of tied-aid credits. Proposals have been put forward for stricter notification procedures—whereby an OECD member offering a tied-aid credit must notify others in advance, to afford them a better chance to respond in kind, and—more generally—to discourage this practice. Other proposals have aimed to tighten discipline by raising the minimum permissible "grant element" of tied-aid credits so as to restrict their use in financing commercial export sales.

The April 1985 meeting of the OECD Ministerial Council achieved progress on both transparency and discipline. The session concluded with an agreement to reinforce advance notification and consultation procedures for countries offering tied-aid credits, and to increase to 25 percent (from 20 percent) the minimum allowable grant element for such transactions.

The Arrangement

The OECD Arrangement of 1978 succeeded a looser 1976 "consensus" that sought to harmonize official export credit practices and reduce the level of subsidy so that trade decisions would be based mainly on nonfinancing considerations.

As well as setting floors on interest rates and ceilings on the repayment terms of traditional export credits, the Arrangement stipulates the minimum cash downpayment required, and the allowable government support for local costs (costs incurred in the importer's country that are associated with the export transaction), as provided for in the original consensus. Cash downpayments must be at least 15 percent of export contract values, with official support limited to insurance and guarantees against the usual pre-credit risks. Official support for local costs—direct financing or insurance—must not exceed the downpayment and may not carry terms more favorable than the export credit to which it is related; local-cost support for buyers in high-income countries is limited to insurance or guarantees.

Modifications, 1983

The Arrangement is not legally binding in the sense of an international treaty and has had a history of rather uneven cooperation. In its original form it had a number of weaknesses. The most important of these was the difficulty of adjusting the minimum allowable interest rates. The latter varied, together with the maximum repayment period, according to the income level of the importer's country, with the most concessional terms reserved for the poorest borrowers. The minimum allowable fixed rates could be increased only by unanimous agreement on a new set of rates—usually after difficult and protracted negotiations. The result was that in the late 1970s and early 1980s, the budgetary burden of subsidies for export credit swelled to enormous levels in several industrial countries, which had promoted exports by offering export credit rates at the Arrangement minimums, but needed to pay higher interest costs to obtain funds in the market to sustain these credits. For example, in 1982 government bond rates averaged 15.6 percent in France and 12.9 percent in the United Kingdom, while the minimum allowable rate specified in the Arrangement was at 10 percent for credits to most developing nations.

One estimate suggests that in the early 1980s export credit subsidies were costing taxpayers in industrial countries about $6 billion a year, because of the large spread between the rates at which export credit agencies borrowed and relent funds. Beneficiaries were buyers in developing countries who were able to finance imports at much lower than commercial interest rates, and exporting firms, which enjoyed increased sales and profits.

A second weakness of the Arrangement was that its minimum allowable lending rates for government-backed credits (which entail direct government financing rather than insurance) applied to lending in all currencies, even those of countries whose market interest rates were below the minimum Arrangement rates. This had the effect of penalizing lending countries whose policies resulted in lower market interest rates.

Largely because of the fiscal pressures exerted by the high budgetary cost of export finance subsidies, participants modified the Arrangement in 1983 to address both of these problems. A formula was adopted whereby minimum interest rates would be adjusted regularly and automatically in line with movements in market rates. The formula provides for the adjustment of minimum rates on January 15 and July 15 each year, if the weighted average of the long-term government bond yields for the five currencies constituting the SDR valuation basket has moved by at least 50 basis points (i.e., ½ of 1 percent) in either direction from the level of the previous adjustment. The latest adjustment, effective July 15, 1985, maintained the interest rate minimums set on January 15, 1985 (see table) as the decline in the weighted average SDR interest rate did not change by at least 50 basis points.

In addition, the participants in the Arrangement adopted individual formulas—subject to periodic review—for currencies where market interest rates were below the Arrangement minimums. In these instances, market-related "commercial interest reference rates" serve as the minimum allowable official lending rates. In most cases, the reference rates are calculated by adding a margin above the monthly average government borrowing costs of five-year, fixed-rate funds, plus a 0.2 percent mark-up, and are adjusted monthly. Reference rates are in effect for a number of currencies, including the Japanese yen, the deutsche mark, and the Swiss franc, which are heavily used for export finance.

Linking the Arrangement minimums to market rates has, in principle, served to eliminate direct subsidies on interest rates for official credits to industrial countries—whose minimum allowable rates more closely approximate market rates—and to reduce significantly the subsidies to developing coun-

Financing for export promotion

There are a number of ways in which financing can be provided—for the purpose of export promotion—on terms that are softer than for traditional export credits. These include:

Tied-aid credits are broadly defined as aid credits provided for development purposes with procurement limited to the donor country; aid is "untied" when procurement may be undertaken at least in all OECD countries and developing countries.

Associated financing transactions, a more narrowly defined concept, combine two or more of the following: 1) ODA with a grant element of at least 25 percent; 2) other official flows—except as in item 3—with a grant element of at least 20 percent; and 3) officially supported export credits, or other funds at or near market terms.

Mixed credits are a kind of tied-aid credit or associated financing that combine funds partly from public sources and partly from private sources.

The grant element of a credit is the measure of concessionality of an officially supported credit, expressed as a percentage, as defined by the OECD Development Assistance Committee. In essence, it is the difference between the interest rate of the credit and the market rate and the length of time the funds are available to the borrower.

tries. The minimum rates are not always observed, however, and the level of subsidization still grows when market rates rise between the semiannual adjustments of the minimum allowable interest rates. Moreover, the minimum rates may still be highly concessional when credits are extended in weaker currencies or where domestic market rates are well above Arrangement minimums.

The Arrangement continues to be limited in several other ways. It does not, for example, cover several important economic sectors—notably agriculture, civilian aircraft, and military hardware—although separate negotiations on these are under way. (Sectoral agreements on ships, nuclear power plants, and aircraft are in effect.) Nor does the Arrangement cover certain auxiliary forms of protection for exporters, including insurance against inflation (or "cost escalation") and fluctuations in exchange rates—forms of protection that tend to blur the distinction between insurance and direct financial assistance.

Tied-aid credits

Once the automatic adjustment of Arrangement rates was agreed upon in 1983, the focus of negotiations shifted to tied-aid credits. Under the recently amended Arrangement, aid funds may be mixed with export credit only when the overall grant element of such mixed financing packages is at least 25 percent (forcing a minimum aid component). The use of more concessional (e.g., with grant elements exceeding 25 percent) tied-aid credits has, however, become widespread. Particularly controversial is the use of tied-aid credits for major export contracts to the financially stronger developing countries (which require less concessional funds), where the concessional element enables the exporter to gain commercial advantage over competitors from other countries.

The proportion of tied-aid credits in total world trade and aid remains quite limited, and indeed the volume of actual tied-aid credit commitments has reportedly declined in recent years. The OECD puts the volume of associated financing commitments at $2.0 billion in 1983 and in 1984—compared with $4.6 billion in 1982. (The significance of these figures, however, may be understated owing to the large dollar appreciation in 1983–84 that reduces the dollar equivalent of these flows.) Associated financings are estimated to account for only about 6 percent of officially supported export credits to developing countries.

OECD arrangement on officially supported export credits

Importing country[1]	Maximum period for repayment: 2-5 years	5-8½ years	8½-10 years
	(Annual interest rate, in percent)		
Relatively rich (GNP per capita of $4,000 or more)[2]	12.00	12.25	—
Intermediate (GNP per capita $681-$4,000)[2]	10.70	11.20	—
Relatively poor (GNP per capita less than $681)[2,3]	9.85	9.85	9.85

Source: Organization for Economic Cooperation and Development.
— Not applicable for these countries.
[1] As defined in the text of the OECD Arrangement.
[2] Based on data in the *World Bank Atlas*, 1981.
[3] Countries eligible for credits from the International Development Association and other low-income countries.

Nonetheless, pressure for increased associated financing seems generally to be mounting, and there was a sharp rise in 1984 in the volume of tied-aid credit offers. Tied-aid credits are highly attractive as an export marketing device since the terms on the concessional part can be very generous—with grace periods that can reach 15 years, maturities as long as 30 years, and nominal interest rates as low as zero percent. Consequently, new associated finance credit schemes have been adopted—or budgetary allocations for their extension increased—in nearly all OECD countries and the number of offers has risen considerably. Furthermore, there is some concern that the incidence of the practice is understated, since many similar types of financial offers are not technically considered tied-aid credits.

Another reason behind the increase in tied-aid credit offers is that in recent years many developing countries have been unable to accept financing on purely commercial terms. The sharp cutback of new investment projects in many heavily indebted countries has intensified competition in financing offers for export contracts to developing countries in financially sound condition. Moreover, the tightened Arrangement rules on minimum allowable lending rates may have encouraged greater recourse to tied-aid credits as a competitive tool in extending official support to exports, especially for products facing weak demand.

France has long been the major user of tied-aid credits, although Italy, Germany, and some smaller European countries have occasionally extended them for special programs generally restricted to poorer developing countries. The United States, the most vocal opponent of tied-aid credits, has made several mixed credit offers to date—only one of which has been accepted. The outlook for additional US offers is not bright—notwithstanding a tied-aid credit program authorized in November 1983 to counter foreign offers and rising domestic pressures in favor of them—as it depends mainly on the lending authority granted by the US Congress for the Export-Import Bank (more immediately, for fiscal 1986), and also on the availability of limited aid funds that can be used for this purpose.

OECD member countries remain divided over the desirability of tied-aid or associated finance credits. At a December 1984 meeting of the OECD Export Credits Group, the United States proposed that tied-aid credits containing a grant element of less than 50 percent be considered purely commercial and thus be subject to the Arrangement minimums. The member countries of the European Community offered a counterproposal to improve transparency further by broadening the definition of tied-aid credits and strengthening the notification rules. The European Community subsequently indicated a readiness to raise the minimum grant element for tied-aid credits from 20 to 25 percent. This compromise was accepted at the April 1985 Ministerial session, at which participants also agreed to tighten notification and consultation procedures along the lines proposed by the EC. The tightening was achieved by requiring that offers of tied-aid credits with grant elements of between 25–50 percent be subject to 20-day prior notification, and by instituting a procedure of face-to-face consultations where there is heavy competition in tied-aid credit offers. A study by the OECD

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Secretariat, to be completed by September 30, 1985, will, according to a communiqué issued at the conclusion of the OECD Ministerial Council, permit prompt implementation of measures to enhance transparency and discipline.

The OECD Development Assistance Committee has also long been concerned with this issue. It adopted in June 1983 "Guideline Principles for the Use of Aid in Association with Export Credits and Other Market Funds." The aim of these guidelines, which are not legally binding, is to limit the risk of distorting trade and aid flows, by limiting the use of associated financings to transactions that promote priority development objectives in recipient countries. In addition, credit terms are to be tailored to the economic situation and developmental stage of the recipients, with strict restraint on the use of concessional aid funds for the financially stronger countries. Experience suggests that the guidelines may be too general to have major impact on associated finance practices. Nevertheless, a recent assessment by the DAC indicates that some members have stepped up efforts to ensure that associated financings are used more for projects having developmental priority; the review also reveals that the share of bilateral ODA used for associated financings in stronger developing countries has declined to less than 1 percent. Considerable progress has been achieved in improving the transparency of associated financings according to the DAC, with new reporting routines established, more clearly understood definitions, and more prompt and complete reporting of data.

Conclusion

It can be argued that any increased use of tied-aid credits diverts scarce, highly concessional foreign aid funds from the poorest developing countries to higher-income developing nations, and from projects to meet basic human needs toward more capital-intensive sectors, which account for a large part of tied-aid credits. For donors, tied-aid credits represent a very costly means of export promotion.

Whether the recent modifications will satisfy the United States' and several other industrial countries' desire for more significant curbs on tied-aid credits remains to be seen, and it is certain that negotiations will continue at their usual slow pace. The achievement of automatic adjustment of OECD Arrangement rates to market levels, however, certainly demonstrates that breakthroughs in OECD export credit negotiations are possible—especially when a particular practice has spread to the point where it is extremely costly and offers no single donor country a clear competitive edge. F&D

Nongovernmental

A review of the role of private agencies and voluntary organizations in the development process and the Bank's cooperation with NGOs

Vittorio Masoni

Nongovernmental organizations operate under different names and different guises in both developed and developing countries (see box on their nomenclature.) Their work is parallel and often quite complementary to that of official development agencies. They are traditionally known for their humanitarian, relief activities: they move quickly to the front lines when an emergency arises, be it famine, forced migration, or a natural or man-made disaster. Less appreciated, but no less important, is NGO work in socioeconomic development, from village-level production projects to involvement in country development policies as the "voice of the poor and of the under-represented." In addition, as a "coalition of consciences," "global think tanks," "do-gooders" or the "independent sector," as they are referred to in a variety of contexts, NGOs seek to sensitize the public in industrial countries to North-South interdependence, and urge more generous development assistance.

In spite of the heterogeneity of NGOs, two themes run throughout their development work: (1) *self-reliance:* people can do much to help themselves (or help others) without government intervention or support from aid agencies; (2) *people's participation:* people are the protagonists of development. People have to be associated with development planning and implementation, and must be given freedom to operate in areas that the government cannot effectively reach. Even the best development blueprint will not improve the lot of the poor, unless the intended beneficiaries understand it and support it.

The current worldwide search for ways to make optimal use of very scarce resources and stimulate broad-based development makes it very timely for economic development agencies to take stock of NGO development activities and thinking, and strengthen collaboration among public and private institutions engaged in promoting growth with social equity. Private philanthropy and self-help associations have a long history and, in fact, predate development agencies. The latter have long endeavored to set up collaborative relations with NGOs, particularly since the 1960s. These relations have been inspired by an ideological blueprint, such as helping a newly independent country to develop a pluralistic society (a view widespread in the United States) or advance social democracy (a motivation common in Europe, particularly among Scandinavian countries). Pragmatic considerations have prevailed with aid agencies that look at NGOs in a functional way, that is, as more efficient conduits for development inputs. Some relationships have been structured through specialized institutions and procedures; for instance, the European Community and most bilateral aid agencies have substantial programs for NGO projects. The World Bank carries out a policy dialogue and operational cooperation with NGOs (see discussion below.)

The wide variety of NGOs and of country situations has so far discouraged comprehensive research on NGOs. A small body of analytical material is becoming available from the OECD Development Assistance Committee, development agencies, and academia

organizations and development

on NGO successes and failures in development. NGOs themselves are more forthcoming in presenting their views on development in a systematic manner (see, for instance, *Private Voluntary Organizations as Agents of Development,* Robert F. Gorman, editor, Westview Press, 1984.)

Size of activity

It is hard to measure the size of the independent sector. NGOs do appear to have vast resources at their command. In 1983, donor NGOs from the OECD countries extended grants worth $3.6 billion to developing countries, about 13 percent of DAC ODA. Of this amount, $2.3 billion were raised directly by the NGOs from the public and from their endowment funds. The balance came from government contributions. This expenditure is only a distant proxy for the overall development work of NGOs in the Third World. To complete the picture one should add the value of the work of countless NGO volunteers and sympathizers: teachers, "curb side" or "bare foot" doctors, social workers, rural extension aides, members of women's associations or of village work brigades, etc. Further, the resources of schools and training centers, hospitals, cooperatives, food aid networks, publishing and mass media enterprises, and so on, owned and controlled by NGOs, should be taken into account.

The OECD Directory of NGOs lists 4,000 organizations based in the industrialized world. Many more operate in developing countries. Religious movements and organizations, a major factor in private philanthropy and the public quest for social justice, are just as widespread in the Third World as in the OECD area. Developing countries are home as well to a multitude of self-help organizations—emerging from the extended family and village mutual support systems. NGOs are present in all societies. Christian missionary schools, Buddhist Sangha literacy courses, and Quran reading classes, for instance, are important for mass education in many countries. The equivalent of Indonesia's "gotong royon" (village volunteer groups engaged in a common task such as seasonal agricultural work, e.g., planting and harvesting) can be found in rural communities throughout the world. The West African "tontine," or collective saving pool allotted, in turn, to each member according to his or her share, is paralleled by credit unions in Latin America and by service cooperatives in India, the Philippines, and many other countries.

The contribution of private, nonprofit groups is indispensable in development programs requiring the participation of a large number of direct beneficiaries. Local presence and special commitment to the betterment of the lives of their members makes local NGOs the only practicable—not just the most cost-effective—link between large-scale investments and the farmer or the city dweller at whom the investments are directed. The target groups for development efforts must be reached in ways that are intelligible to them, in other words, that can be connected with their lives and work. NGO sensitivity to such concerns and their local knowledge and operations usually cannot be matched by government departments.

Nature of work

NGOs perform extremely well in community mobilization. Discouraged, disorganized, and ill-informed, the poor are often unable even to exploit opportunities for improvement that are at hand. NGOs help set the stage for change by rallying communities around a common objective, preferably a short-term and easy undertaking. The objective must be chosen by the people; individual participation in the project must be voluntary. Family bonds and other affiliations are taken into account in planning an individual's role in the project. Communication between the NGO team and village people is face-to-face and most of the instruction is on-the-job.

Achieving the first communal objective increases people's confidence in their ability to help themselves; their newly gained sense of self-reliance inspires the community to pursue other, more important objectives, such as a credit union, an individual enterprise or partnership, a communal fishery, a mother and child clinic, or a reading program for school drop-outs.

At a certain stage external resources become necessary. Typically, this is the point at which NGO activity can be taken into account by an organization such as the World Bank. Whether the people need funds, technical assistance, or a change in policies (e.g., removal of price controls, or a law to encourage private cooperatives), the NGO can arrange assistance on their behalf from the government, from an external development agency, or from donor NGOs, as the case may be. Later, the pioneer NGO can contribute the unique experience it has acquired toward the realistic planning and design by the public sector of large-scale projects involving a number of villages. Then the organization may well participate in the implementation of a suitable component of the larger project.

In addition to their project work in the field, NGOs operate at a broader national and international level. NGOs have proven their ability to mobilize public opinion to help victims of drought and starvation in Africa through mass media and their own extensive publishing and information systems. Churches, national NGO consortia (e.g., Interaction in the United States), people's movements (e.g., Mani Tese in Italy) have raised considerable funds for the emergency in Africa. They also have raised public awareness about the need to increase official assistance to African countries, for both relief and development. The debate generated by policy proposals such as the World Bank's reports on sub-Saharan Africa has found a broad response in the NGO information network. NGO correspondents from Africa have provided immediate reports on famine and health situations, flows of refugees, availability of local relief resources etc., helping other NGOs and the international community in the design of appropriate programs. Policy-oriented NGOs with long experience in Africa and with local staff have given development agencies insight on policies for food security, health and population, resettlement of populations, and informal education.

There are many examples of successful NGO work in support of development programs. They include original work of Maisons Familiales Rurales of Paris with peasants' communities in Africa and elsewhere; mass training by Accion Cultural Popular in Colombia and by INADES, Institut Africain pour le Developpement Economique et Social, throughout Africa by means of television and correspondence courses; support by the Aga Khan Foundation (Pakistan) for health services and higher education in Pakistan and Kenya; the pioneering work by Oxfam (UK) in production and marketing of handicrafts from the Third World; food-related programs of premier organizations such as Caritas Internationalis, Catholic Relief Services (US), US CARE, and Save the Children (international). Other leading examples of NGO work in support of development in the Third World include banking for the poor provided by the Ecumenical Development Cooperative Society (international); support to local institution-building of Misereor of Germany; working in the spiritual and economic fields of the Organization for Industrial, Spiritual and Cultural Advancement (OISCA) of Japan, and of Sarvoydaya of Sri Lanka; and the financial and project work of the Ford and Rockefeller Foundations. This is only a small sample of the wide range of NGO activity.

A Guide to NGO Terminology

NGOs are also referred to as private voluntary organizations. In much of the Third World, however, the terms NGOs and PVOs denote foreign entities; local denominations, such as national self-help or self-reliance organizations, are preferred for indigenous organizations. NGO terminology is not yet well established since NGO typology is still uncodified. Following is an attempt at identifying major NGO categories, although with some approximation and overlapping. The first two categories are fundamental.

Philanthropic NGOs are moved by altruistic considerations, either religious or secular, e.g., church charity groups and private foundations for humanitarian purposes.

Self-help NGOs are motivated by economic self-interest or self-help objectives. They would serve professional groups (e.g., women's associations) or act as a cooperative.

NGOs that belong to either of the two preceding basic categories are further distinguishable as follows:

Welfare NGOs aim at providing succor to people, whatever the reason and circumstances of their need for assistance and, generally, without plans for addressing the cause of the distress.

Development NGOs aim at promoting ultimate self-reliance of their beneficiaries. If the beneficiaries are members of the NGO, the organization is of the self-help type; otherwise it is philanthropic.

Donor NGOs are prevalent among NGOs based in industrial countries and generally fall in the philanthropic category.

Local NGOs are NGOs from developing countries or indigenous NGOs; they fall primarily in the self-help group.

Operational NGOs specialize in the application of development resources. They include *program agencies*, that is, structured entities with access to continuing financial resources, specialized staff (often deployed in the field), and planned development activities; *relief assistance organizations* equipped to help after disasters, to run food aid programs, assist refugees, etc.; and *service NGOs*, that are sources of technical assistance.

Funding and policy NGOs gather development resources, be these funds, food, or political support for aid. Among them, some are specialized in *fund-raising*. Others engage in *development education* providing information about development, its objectives, strategies, and consequences both for donor and recipient countries. An important subgroup includes the policy *research and public debate* organizations that concentrate on international economic relations and development issues. These "North-South think tanks" are often private foundations—some linked with major universities.

Network NGOs have affiliates, correspondents, sympathizers, and volunteers, as the case may be, in several countries. Among them *international NGOs* have members or operations in more than one country. *NGO consortia* (or "umbrella" organizations) can group either donor NGOs or local NGOs. Some consortia act as money or data banks for their members; others provide common representation with agencies or at international conferences; others still function simply as a meeting place or information clearing house.

Sectoral NGOs deal with one or few sectors, such as rural water supply.

Integrated NGOs strive to respond to a broad range of needs of a population, such as education, health, and urban and rural development. Some of these groups pursue a holistic ideal of development, endeavoring to integrate people's spiritual and economic needs.

Incorporated NGOs have a formal status, often linked to tax exemptions or other concessions in the country of origin or of operation.

Recognized NGOs have status with certain organizations. For instance, the UN has a system for the accreditation of NGOs.

Informal NGOs are groups of like-minded people (sometimes called a "movement") working for a common development purpose without legal bonds. Many Third World NGOs belong to this category. These groups can be permanent or constitute a once-for-all coalition for a single, time-bound objective, e.g., agrarian reform or legislation to protect the environment.

Different approach

The NGO approach to development does differ from that of government agencies or of an international institution such as the World Bank. Exhaustive, hard analysis of these differences does not yet exist. Sustained observation suggests, however, that a number of differences are more apparent than real. It may be useful to highlight the major ones since they hinder cooperation between the public and the private voluntary sectors.

NGOs work at the microlevel while agencies support large-scale projects. But most large-scale projects that interest NGOs are not in lieu of microprojects. They are composed of microprojects. Even the largest development program must be broken down to the size of the farm, the city block, or the school and be seen in terms of the ultimate beneficiary. Micro- and macro-approaches are complementary.

Development agencies maintain that programs must be supported by institutions commensurate to the task and that, therefore, large projects require a bureaucracy, i.e., a corps of planners, administrators, technicians, etc. Direct assistance, "from people to people," is still the ideal for many NGOs. However this approach cannot combat massive poverty: spontaneous mass replication of self-standing, isolated NGO projects is very unlikely. To achieve maximum advantage of both the official and the NGO approach the public sector should provide a policy and financial environment that fosters NGO activities in support of official development programs.

In the tradition of philanthropy, NGOs generally make grants whereas development agencies normally operate through loans—albeit on concessional terms. Development agencies do appreciate, however, the need for risk capital in a number of situations: research and experimentation, or institution building that may have only indirect, uncertain, or very long-term effects. NGOs recognize the limitation of funds available for grants and increasingly seek to go beyond charity by charging for services and supporting income-generating programs.

Most NGOs strive to work independently of government agencies. They argue for greater political power for the poor as a counterweight to the influence of the rich and the well organized. This position is widely shared by NGO leaders, ranging from Mr. Ariyaratne of Sri Lanka to the liberation theologians of Latin America. Conversely, government officials often express reservations about NGOs, sometimes on the grounds

that they see NGOs pursuing hostile political goals or engaging in activities that disrupt overall development. The more authoritarian and centralized the regime, the louder the complaints. But observers from development agencies, development scholars, and even other NGOs often criticize individual NGO programs as unnecessarily confrontational, erratic, or fragmented. In practice, most NGOs accept an evolutionary view of development; they operate in an environment largely shaped by the government and collaborate with government agencies. Most governments deal with most NGOs as legitimate organizations and value their work in development. Many governments have special offices to foster cooperation with NGOs. Line ministries, in particular, assign officers to liaise with NGOs for operational purposes, for example, the Ministry of Population and Environment in Indonesia and the Central Planning Commission in India. In certain countries, such as Niger, there are joint government-NGO councils.

The fact that differences can be conceptually reconciled should not even remotely suggest that, in practice, solutions would be easy. One has only to think about the difficulties surrounding rural cooperatives, the most important NGO in many LDCs, which are plagued by bureaucracy, loans in arrears, factionalism, domination by the rural power elite or by officials and, sometimes, by erroneous government regulations.

NGOs have gone well beyond short-term relief operations and generic support for equitable development. Religious and lay organizations have evolved specific views about fundamental issues: need for indigenous not imported models of development; development as a process to enable people to become self-reliant, not just to raise GNP per capita; the role of the individual in development; balance between economic and noneconomic needs in a given society; pluralism of development institutions—large and small—as a prerequisite for self-sustained and fair development. Their models for people's participation in development have been tested in the field. Their experience with labor-intensive programs and the use of local technologies and materials is considerable.

The contribution of NGOs to the definition of a "humanistic" model of development and of the strategies for balanced, self-sustained growth has been useful. But for NGO views and experience to have greater impact they need to be more widely known and need to be coordinated with the work of the other institutions concerned with development, that is, governments, international agencies and, to some extent, the business sector.

Such an approach would produce useful exchanges and perhaps critical debates. It would also help shed light on some of the sources of conflict rooted in systemic differences between the two sides. To illustrate this point with a very specific example: the Roman Catholic church has repeatedly stressed that the priest is not a social worker. The development technocrat must draw operational lessons from this; he or she cannot simply continue to count the churchmen in rural areas as agricultural extension workers, or look at churches as potential health care centers. Clear and reasoned debates would help define realistic expectations about, and practical methods for, effective collaboration between NGOs and development agencies to promote growth with social equity.

World Bank and NGOs

Bank-NGO relations can be viewed in two parts: multilateral relations, anchored in the Bank-NGO Committee, and bilateral relations, resulting in cooperation in operations or research between the Bank and qualified NGOs, whether or not members of the Committee. When the Bank entered the sectors of rural development, primary and vocational education, and basic health care in the late 1960s, it stepped into the very home ground of the NGOs. Cooperation in the field between the Bank and NGOs became more frequent and gradually a web of *ad hoc* relations developed. At the end of the 1970s, evidence of mutual interest in more systematic and extensive cooperation resulted in the establishment of the Bank-NGO Committee and the issue, in 1981, of the Bank guidelines to its staff for cooperation with NGOs. The Committee currently includes five Bank senior staff and twenty representatives of a broad spectrum of NGOs from developed and developing countries. The International Council of Voluntary Agencies of Geneva acts as the NGO members' secretariat. The Committee has two cochairmen: the Director of the Bank's International Relations Department and the Executive Director of the Canadian Council for International Cooperation. The Committee meets once a year. Initially focused on operational cooperation, it now deals also with development policy issues and development education.

The policy dialogue at the Committee concentrates on the changing world economic environment and its implications for developing countries' development programs, for aid agencies, and for NGOs. It also covers specific areas: in the 1984 and 1985 meetings, for instance, it included coordination of relief and reconstruction work after man-made or natural disasters, food security, and strategies for the recovery in sub-Saharan Africa.

Development education issues are also discussed at the Committee to identify opportunities for participation in information events of common interest, and to exchange documentation, teaching material, and perceptions on international development issues.

Cooperation with NGOs in sector or project work necessarily calls for a trilateral relationship in which a government has a central role, since the Bank lends only to, or through, governments. Cooperation is often informal: an NGO provides advice on project design suited to local conditions; Bank staff inform NGOs about broad development programs in the country that may pave the ground for NGO initiatives; agreement is reached to avoid overlapping or to build on complementarities between an NGO program and a Bank-financed project. Cooperation can also be formal (that is contractual): the NGO implements part of a project, acts as consultant to the borrower, or provides financing.

Particularly effective in encouraging borrowers to take NGO activities into account—an important element of the Bank policy toward NGOs—are trilateral consultations among government, NGOs, and Bank staff to discuss area or sector development issues. Successful trilateral meetings have recently been held in Eastern and Southern Africa and Indonesia on education, health and population, and multisectoral cooperation. These meetings usually result in specific cooperative agreements and are likely to be replicated in other countries and other sectors.

While it is much too early to evaluate the specific results of Bank-NGO collaboration, the relationship evolving under the guidance of the Bank-NGO Committee is proving to be mutually beneficial. Cooperation with the private voluntary sector can strengthen the activities of development institutions such as the World Bank. Such cooperation could also assist NGOs in widening their impact on development programs. Through the policy dialogue with agencies such as the Bank, NGO work can be placed in a broader international economic perspective, thereby allowing NGOs to participate in discussion of, and action on, development issues in industrial countries as well as in the Third World. F&D

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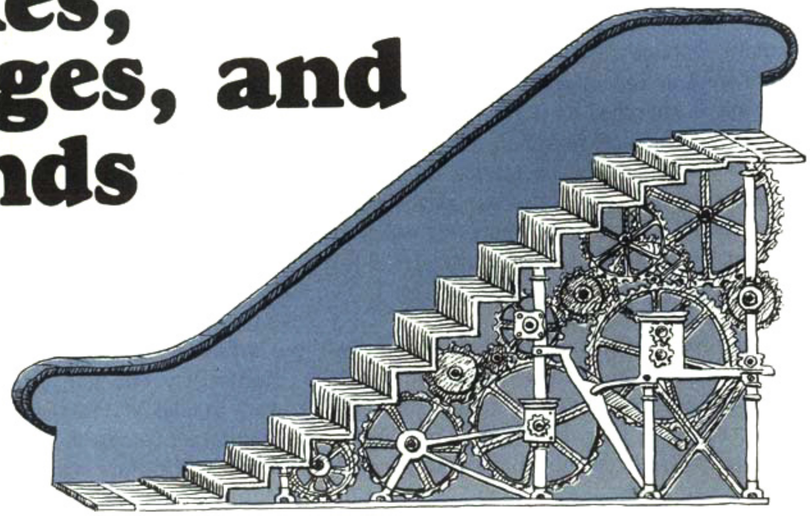
Nominal indexation of taxes, wages, and bonds



An introduction to the concepts and issues in implementation

Liam P. Ebrill

The widespread emergence of inflation during the 1970s led to much interest in indexation mechanisms, particularly in those countries with relatively high inflation rates. Such mechanisms, while differing in form and coverage across countries, essentially involve the *automatic* linking or indexing of the nominal values of certain economic variables to movements in price indices.

While indexation mechanisms can, in principle, be applied to all payments or values denominated in terms of money, such arrangements have, in practice, proved more popular in some contexts than others. Most common is the use of cost-of-living adjustment clauses in labor contracts. In financial markets, indexed bonds have been issued in some countries: such bonds provide a link between nominal returns and changes in prices. In some countries, personal income tax brackets have been automatically adjusted for inflation, so as to avoid undue rises in tax liabilities due solely to inflation. Other elements of tax systems, such as the treatment of depreciation allowances, have also in some cases been indexed.

The underlying motivations for indexation arrangements are clear. Such arrangements reflect a desire to insulate the real variables of economies from the effects of inflation, and to avoid some of the costs of frequently renegotiating contracts when prices are changing.

It is possible to conceive of situations in which indexation mechanisms can be beneficial. Consider, for example, the case of tax indexation schemes which have been implemented so as to ensure that the real impact of tax systems is unaltered by changes in price levels when inflation rates are very high. However, more generally, the experience has been that indexation mechanisms can have adverse real and monetary consequences. On the real side, such mechanisms have frequently been too rigidly applied, obstructing necessary adjustments in relative prices. As practiced, indexation schemes have all too frequently been based on past changes in prices leading to inappropriate changes in relative prices. Further, when inflation rates are changing, and such mechanisms have only been applied to particular classes of payments, significant changes in relative rewards have sometimes occurred. On the monetary side, the widespread adoption of indexation has sometimes been felt to introduce significant inertia into the inflation process and to lead to difficulties in eventually bringing inflation under control.

In the remainder of this article, these themes are covered and elaborated upon in the context of three forms of indexation: the indexation of taxes, wages, and bonds, particularly government-issued bonds. Given the limited space available, the treatment of topics is brief and selective. For example, the topic of exchange rate indexation is not explicitly discussed.

Tax indexation

Indexation of taxes provides an example of the purpose of most indexation regimes, namely, to insulate payments against unintended variation caused by inflation. Many tax systems were set up at a time when rates of inflation were low. When inflation subsequently increased, a number of unintended allocative effects emerged in some countries.

The nature of these effects can vary greatly, depending on the provisions of individual countries' tax systems. However, a couple of general observations can be made. First, many personal income taxes are progressive in terms of nominal income, with the result that inflation tends to drive taxpayers into higher tax brackets. While such an effect enhances the elasticity of the tax system, it tends to be arbitrary and capricious and, clearly, increasing marginal tax rates can have serious implications for work effort. This effect can, in principle, be avoided by indexing the personal income tax structure.

More serious is the fact that, in the absence of indexation provisions, many tax systems do not treat the incomes from labor and capital symmetrically. Even a proportional tax on capital income tends to discriminate against capital, if the tax is based on nominal as opposed to real capital income; such a system fails to recognize that some proportion of the yield on a capital asset may be compensation for inflation. As a result, increases in the expected rate of inflation may adversely affect the real returns earned on typical assets, often resulting in negative real rates of return. This problem is compounded if other assets exist whose nominal returns are untaxed. In some countries, an example of such an asset is owner-occupied housing. In those countries, not only may the implicit return to owner-occupied housing be untaxed but mortgage interest may also be deductible. If mortgage rates rise in line with inflation, increases in the expected rate of inflation will tend to subsidize additional investments in housing. As a result, changes in inflation may encourage capital owners to move capital in response to inflation-induced changes in relative asset yields rather than in response to movements in the underlying productivity of competing investment opportunities.

Indexing, in principle, again offers a solution to this type of problem. For consistency, it should occur on both sides of the balance sheet. (For example, in many corporate tax

systems, interest on debt is deductible. As a result, any move to insulate those tax systems from inflation by indexing depreciation allowances and so on should also recognize that deductible interest payments may be influenced by inflation levels.) In fact, the solutions implemented in practice tend to be partial, with only some elements, such as depreciation allowances and inventories, being indexed.

The above discussion glosses over a number of problems. There are many practical difficulties associated with the implementation of tax indexation. For example, what is the appropriate price index to use? Further, the introduction of tax indexation schemes may have a negative impact on a government's budget, aggravating an imbalance that may have had a role in the inflationary process in the first place. (This effect ignores any influence inflation may be having on government expenditures.) The result is that any decision to implement a tax indexation scheme must find a balance between these considerations, on the one hand, and the fact that tax indexation may ameliorate some of the arbitrary effects of inflation on rewards, on the other. Tax indexation tends to be introduced in countries with rates of inflation so high as to preclude the repeated use of ad hoc solutions, such as statutory tax bracket changes or accelerated depreciation allowances based on historical cost. This has been the case with countries such as Argentina, Brazil, Chile, and Israel.

Wage indexation

While indexation can, in principle, be applied to incomes from all sources, it has often been the case that the income generated by labor has been the subject of the most extensive indexation arrangements. This has reflected both the significance of the share of labor in national income, and that fact that the protection of the rewards earned by labor has been a matter of high social and political priority in some countries. Wage indexation arrangements have, in some instances, been the outcome of agreements between employers and employees, while, in others, they have come about as a result of social contracts involving the public as well as the private sectors.

The reasons why wage indexation arrangements might tend to emerge during periods of inflation are well known. They include the avoidance of the costs of frequently renegotiating contracts when prices are changing and the reduction in uncertainty about the future purchasing power of income that indexation can afford. The interests of both employers and employees are relevant. Under certain conditions, wage indexation may be a natural response to both sets of interests in light of the uncertainty implied by inflation. Thus, nonindexed contracts that involve fixing nominal wages for lengthy periods of time, perhaps on the basis of expectations about the course of inflation, impose risks for both employers and employees. For employers, there is a risk that the level of inflation will turn out to be lower than that which was expected, implying a lower level of profits. For employees, there is the risk that inflation will turn out to be higher than expected, leading to a reduced purchasing power of income.

To the extent that the risks faced by employers and employees are equal and offsetting, there is a gain to negotiating indexed contracts; such contracts, by tying the evolution of wages to the movements in an agreed-upon price index, imply that *both* employers and employees can insure themselves against the consequences of unexpected movements in inflation. In practice, however, the gains and losses to employers and employees are unlikely to be equal and offsetting. While employees will be most concerned about the value of their incomes in terms of a diversified basket of goods, employers will be most immediately concerned with the evolution of the prices of the products they produce. The risk of changes in these prices relative to prices generally implies that the risks faced by employers and employees typically do not precisely cancel each other. Under these conditions, optimal wage indexation will, in general, involve some provisions to take account of movements in relative prices; as such, the optimal contract involves clauses which allow for changes in real wages when economic conditions dictate that such changes are appropriate.

In reality, either due to the complexity of negotiating optimal wage indexation contracts or on account of the difficulties in determining the appropriate form such contracts should take, actual wage indexation arrangements have typically only been able to accommodate a limited range of circumstances; in their simplest form, the evolution of wages depends only upon the course of a single aggregate price index. Accordingly, such contracts have all too frequently not allowed for, or have slowed down, necessary adjustments to real wages in response to factors such as shifts in the terms of trade, productivity changes, and so on. Furthermore, such arrangements have often been based on the past behavior of inflation, rather than its expected evolution, over the life of contracts. In periods when inflation rates have changed dramatically, such contracts have often led, therefore, to large changes in real wages, even when economic conditions would not dictate that such changes were appropriate.

These difficulties associated with the practical implementation of wage indexation mechanisms are important. Some have argued that they are sufficiently serious to warrant a re-evaluation of the appropriateness of permitting such mechanisms. Indeed, some countries have taken steps either to limit the use of wage indexation mechanisms or to change their provisions so as to make them more responsive to movements in the underlying real variables of the economy.

Bonds

A useful approach to the merits of government provision of indexed bonds is to begin by considering the rationale for privately issued indexed debt. Analogous to the case of wage indexation, bond indexing can be seen as an attempt on the part of individuals to pool the risks of unexpected price changes. Indexed bonds will tend to come into being when one person's gain is another's loss, thereby offering an incentive for mutual insurance. The fixed yield on a nonindexed bond will reflect, among other elements, some perception concerning future inflation. Should the rate of inflation subsequently be greater than anticipated, the borrower will gain at the expense of the lender. The reverse holds true when the rate of inflation is below the anticipated level. An indexed bond can avoid these kinds of effects, and, provided that the gains and losses to lenders and borrowers offset each other, the yield may not incorporate an inflation risk premium. In the absence of this balancing of risks, indexed bonds would tend, in general, to include some allowance for such risk.

An interesting extension on the risk-pooling or insurance perspective to indexation involves recognizing that wage and bond indexation may be inversely related—if the real wages an individual earns, say, are protected by an indexed contract, that individual will typically be less willing to pay for bond indexation.

Now consider the role of government-issued indexed bonds. Governments issue them to attain some objective. In particular, governments may feel that they are better able to absorb, or have different attitudes toward, the risks associated with price variability. Seen in this light, the issuing of indexed bonds by governments may be justified as a response to the need for individuals to obtain insurance against inflation.

The substitution of indexed for nonindexed debt implies changes, which depend on the subsequent course of inflation, in future government tax payments. This raises the possibility of additional distributional and allocational effects. One way of evaluating these is to consider a benchmark case in which these effects may be negligible. Specifically, consider the case of an individual who is both taxpayer and bondholder. Assume that the

switch to indexed debt results in an increase in tax payments and that the individual in question is aware of this effect. If it is further assumed that the prospective increase in the liabilities is precisely balanced by the change in the yield on his holdings of government debt, then a case can be made for arguing that the individual will be indifferent as between the two forms of debt. Should these circumstances not hold, then a wide range of effects is possible. In particular, when taxpayers and bondholders are not the same individuals, indexed debt may become an instrument for income redistribution either within generations or across generations (to the extent that that debt is retired by the tax payments of subsequent generations.)

Of course, the other side of this scenario is that the use of nonindexed debt raises the possibility of an inflation tax. In the nonindexed case, unanticipated increases in future rates of inflation reduce the cost of repaying outstanding debt. Related to all of these budgetary effects is the possibility that the existence of government-issued indexed bonds may alter the conduct of economic policy. For example, some have argued that their existence might encourage governments to pursue more vigorous anti-inflation policies so as to reduce future repayments if for no other reason than to hold down future tax revenue requirements. Finally, note that by permitting the use of dollar-denominated deposits so as to afford hedges against both domestic inflation and exchange rate risks, some Latin American countries have effectively been permitting indexed financial assets.

Overview

In an ideal world, the indexation of nominal values can help to reduce significantly the costs of inflation. With real shocks occurring, such indexation will generally allow for necessary changes in relative prices, and, with inflation changing in a known and predictable way, indexation formulae would be based on current and not past price changes.

In practice, however, indexation mechanisms have tended not to have these desirable attributes. In addition, they typically have not been uniformly applied across sectors. The result may be significant changes in relative rewards over time. This may be an additional undesirable feature, though any conclusion in this respect should be made with reservations. Thus, as was pointed out earlier, a case can be made for arguing that the optimal amounts of wage and bond indexation may be inversely related. Taken together, the discussion of the three examples of indexation suggests that attempting to adjust automatically for the effects of inflation, while in principle beneficial, can in practice frequently end up generating a new set of problems precisely because actual indexation contracts are not as complete as the optimal contracts of the frictionless world. There are additional issues associated with indexation. Thus, much of the above has addressed topics that arise in association with particular kinds of indexation. As such, it has not dealt with the macroeconomic implications of the widespread use of indexation, and therefore has not fully considered the issue of whether indexation arrangements that have been introduced in response to inflation may themselves have implications for inflation. In this context, concern has been expressed that economies in which a large proportion of nominal variables are indexed may become inflation prone. Some Latin American countries, which have made widespread use of indexation techniques, have had to consider whether the continuance of such arrangements is ultimately consistent with the control of inflation. The emerging consensus is that the adoption of broadly based indexation schemes may often be associated with a range of adjustment problems. It is more preferable to adopt policies which control inflation than indexation policies that are aimed at allowing one to live with inflation. F&D

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Computerizing revenue administrations in LDCs

Automated data processing is no panacea, but in well-organized customs and tax administrations it can expand capacity and improve efficiency

François Corfmat

Developing countries increasingly face decisions on whether or when to introduce computer technology. With efficiency, capabilities, and adaptability increasing, and costs declining, computers seem to offer tempting, quick solutions to an array of problems. This article examines the potential advantages of computers in one area of government administration: revenue collection. More precisely, it provides an overview of the applications of automated data processing (ADP) systems in customs and tax administrations, examines some of the problems associated with implementation of and adjustment to the new technology, and looks at a number of ways in which these problems can be minimized or avoided.

Over the past decade computer technology has become an integral part of the customs and tax administration operations in many developed countries and has significantly increased their capacity to process forms, streamline tax procedures, compile statistics, and use data to improve forecasting of fiscal revenues. Revenue administrations in developing countries also face expanding workloads: the number of taxpayers has grown rapidly; procedures and regulations have become more complex; international trade has increased; and the need to assemble greater quantities of data for economic and fiscal policy making has intensified. Can computer technology play a role in meeting these needs as well?

The answer seems to be a qualified yes. Experience suggests that ADP can increase the efficiency of well-run operations, but could prove useless, and will probably exacerbate existing problems, if it is superimposed on badly organized or inadequately rationalized revenue administrations.

Applications

Customs administration. In customs, ADP systems can be used principally to identify importers, clear goods, manage tariff files, control inventories of warehoused goods, and compile external trade statistics. These functions are usually divided into two categories: central processing and customs office functions.

At the central processing site, maintenance and compilation of the "integrated tariff," and data centralization and information services are the main functions. Automated clearance requires the creation of a set of files (the integrated tariff) that would contain, for each customs tariff heading, all the data needed to verify that goods meet requirements (quotas, licenses, health regulations, etc.) and to calculate the duties and taxes payable. The data centralization and information services of an ADP system are designed to produce external trade statistics; special summaries and studies, such as analyses of import and export prices; and insurance and freight studies. Useful information, such as general accounting, estimation of cost of duty-free and privileged clearances, fraud analyses, and changes in workloads, can also be generated for customs management.

In customs offices, automated clearance of imported and exported goods is the main application of ADP systems. Principal operations include entering, checking, and storing data; printing out of declarations; application of regulations on external trade (e.g., licenses, quotas, prohibitions, and health controls); calculation of duties and other levies; and identifying where document checks and physical examination of goods might be needed. These are normally processed instantaneously (in "realtime"). Less time-sensitive management tasks are often handled through batch processing; this method allows a computer to collect data and process it at a later date (e.g., overnight or at the end of the month) and can be used to maintain official records, produce daily and periodic accounting statements, and compile official activity reports and tables.

Internal tax administration. Tax collection procedures vary from country to country but ADP systems have commonly been used to process returns and payments, assist in enforcement operations, and compile statistics. In processing tax returns and payments, computers can preaddress forms and payment vouchers, check the accuracy and consistency of data reported, calculate taxes, identify computation errors, maintain taxpayers' records and general accounting controls and records, and prepare refund, assessment, and penalty notices. In enforcement, computerized systems can identify defaulters, prepare notices, develop mathematical formulas and statistical programs to select returns for audit, and verify data and identify tax evaders through cross-checking with external sources or other computer files. At minimal cost, ADP programs can also produce operating and statistical reports designed to assist tax managers and policy makers in management and planning, formulation of tax policy, and economic analysis and research.

Internal tax ADP systems that perform

these operations require the comprehensive design of an integrated master file system. The master file system becomes the heart of the tax department's ADP program. It maintains a record of all taxpayers and all accounting, auditing, and collection transactions. Most countries use at least two master files: one for individuals (employed and self-employed) and the other for legal entities, such as corporations. Some countries also use a separate file for tax-exempt organizations. The usefulness of these master files depends mainly on the establishment of a reliable and up-to-date tax identification numbering system that can distinguish one taxpayer's document or record from another's. As a general rule, the master file system should be flexible so that, after a simple start, the system can accept new data from various sources and perform progressively more complex work.

An important function in tax administration is the selection of returns for audit so that limited resources are focused on particular areas to maximize gains in revenue and elicit compliance. In identifying likely candidates for auditing, ADP programs use selection criteria and classification techniques to assign weights to various characteristics involving the high probability of error, change, and evasion. The formulas used in this process are kept secret not only to avoid manipulation of returns by taxpayers but also to ensure impartiality in the selection of returns.

Introduction of ADP systems

In deciding whether or to what extent ADP systems should be used, an important first step is a feasibility study. This would describe current operations; enumerate possible constraints; and determine the performance criteria by which an ADP system would be evaluated. The study's conclusions would provide estimates of costs and benefits in terms of manpower, equipment, and time; compare costs of the various systems; define both personnel and training needs; and provide a statement of objectives.

Potential advantages then must be carefully weighed against possible problems. An ADP system can increase administrative efficiency, reduce costs, improve service, and expand statistical capabilities. But its implementation may displace workers doing routine work, elicit negative reactions from officials ill at ease with the new technology, and create a dependence upon foreign suppliers, who are needed to design and develop the system and to maintain the hardware and software. Many of these difficulties, however, can be offset by increases in capacity and efficiency and by giving staff more interesting and rewarding work.

More serious are the problems related to hiring and training officials and technical staff to implement and operate the new systems. In developed countries, training is often provided for current staff through in-house training courses arranged by computer manufacturers, software designers, and other private companies. In developing countries, training and staffing needs must often be met by hiring new personnel who have been trained outside government service or abroad. Nigeria, for example, has drawn planners and programmers from the training facilities offered by local universities and foreign institutions; Ecuador and Honduras have recruited from a training center for tax administrators that emphasizes ADP. Hiring outside people, however, may create conflicts between new technical staff and the present operational staff. For some countries the use of foreign experts for technical work and for training current staff may offer a more acceptable alternative.

Retaining qualified staff may also present problems. A separate salary scale may be one alternative, though experience suggests it may not be a viable solution in every case. Public service contracts may offer another option. Though problems of confidentiality can arise, contracting has been used successfully in a number of countries. The data processing of the Brazilian Federal Tax Department, for example, is contracted to SERPRO (Serviço Federal de Processamento de Dados), a data processing organization that has the status of a public enterprise and can offer salaries more competitive with the private sector.

Design and implementation

Developing countries introducing an ADP system for revenue administration face a number of important decisions regarding design and implementation. One concerns the structure of the computer system: both centralized and decentralized systems can produce satisfactory results. In a centralized approach, the design, development, and operation of the system are provided by an organization that is independent of any of the tax collecting departments and that is responsible for providing all public entities with the information needed for their operations and decisions. In Zaïre, the Data Processing Service of the Finance Department performs the data processing activities for the Department's various directorates (customs, taxation, budget, treasury, and accounting). In a decentralized approach, the finance ministry may require operating departments to be responsible for the supervision and control of their own computer systems. The US Internal Revenue Service, for example, organizes its operations in the latter manner, as do most of the tax departments of the member countries of the Inter-American Center of Tax Administrators.

While the initial choice may depend upon several factors, including the scale of operations to be performed, capital expenditures, and efficient utilization of computer hardware, one major consideration is the availability of adequate numbers of skilled computer technicians. Because computer costs are falling and the number of available technicians is increasing, and because services provided by the central computer organization might prove unresponsive in terms of either seasonal fluctuations of work or unplanned events (tax legislation changes, for instance), a mixed approach may be preferable and is often applied. Under such a scheme, the central computer of the ministry of finance usually provides services for policy activities and for the ministry's own statistical and national reporting needs, and may, when necessary, provide services on a time-sharing basis for some collection work of the revenue departments. On the other hand, the data processing units of revenue departments operate their own computer systems and perform time-sensitive activities, such as issuing customs clearances, tax refund checks, assessment notices, tax receipts, and answering inquiries.

Data security presents another element in the design of a computer system; control measures must be taken against the unauthorized disclosure of information from customs declarations or tax returns, the fraudulent manipulation of data, and the misuse of terminals by unauthorized persons. A security system is necessary to ensure the integrity of the system, to restrict access to computerized data, and to protect the computer facility against fraudulent intrusion or destruction by natural disasters.

Developing countries will also need to scrutinize foreign-designed ADP projects and related services carefully. Some programs may be inappropriate for local needs or unnecessarily complicated and expensive; excessive enthusiasm by outside experts and hardware salesmen might also encourage administrations to become overambitious. Current ADP systems are sufficiently diversified to allow step-by-step progress. Increasingly, small computers are being used because they use less space, offer better service, and are more flexible than large central computers; and they do so at lower initial and operating costs. The inevitable shift toward more comprehensive and integrated software systems requires the standardization of equipment and, consequently, an appropriate administrative policy to coordinate the needs of the departments that use it. It is important to provide a link between the various computers, both large and small, to enable information to circulate among the different departments of the ministry, to allow users access to more information, or simply to

share costly hardware, such as high speed printers and disc drives for storing information. There are internationally accepted standards for much of the coding and other computer-related processes, and it is preferable to ensure that these are adopted whenever possible.

Technical assistance

A great deal of information and technical assistance is currently available to developing countries that want to automate their revenue administrations. Technical assistance, which includes both personnel and financial assistance, has traditionally been provided through bilateral cooperation agreements, sometimes in the context of a joint commission established to promote cooperation between the two countries. Agreements often involve the participation of customs or tax authorities and private contractors of each country, and sometimes entail the assistance of independent technical consultants and academic institutes. (The US-Saudi Arabian Customs Program, for instance, involved the participation of Arkansas State University, while the French-Egyptian Customs Project was completed with the participation of Grenoble University.)

International organizations have recently begun to offer advice on the design and installation of ADP systems (see box), while independent consultants and specialized institutions are additional sources of assistance. Courses on customs and tax applications of computers are, for example, regularly presented by the Institute for Tax Administration at the University of Southern California, with the assistance of the US Customs Service and the Internal Revenue Service.

A country seeking technical assistance may wish to consider two types. The first would consist of the short-term assignments of customs or tax advisors to conduct feasibility studies, produce cost/benefit analyses of alternative systems, evaluate new programs designed to extend the capabilities of the existing systems, and identify personnel training needs. The second type would consist of long-term assistance, possibly spread over several years by data processing specialists experienced in the application and implementation of all facets of computer utilization for mass processing techniques and operations and familiar with government operations in customs, tax, and budget administration.

Conclusion

Clearly there are potential advantages to properly applied systems of data processing. In customs work, the growing volume of international trade, new methods of transport, increasingly complex regulations, and expanded information requirements may make automation a necessity if developing countries wish to prevent undue delays at their borders and to increase, or even just maintain, their share of world trade. In tax administration, because of additional budgetary needs for revenue, increased compliance with tax obligations and more efficient collection are becoming priorities for developing countries. Automation may eventually offer the most effective means of meeting these needs.

The note of caution remains, however. For many reasons, both administrative and political, the introduction of ADP systems may not always bring about the intended result. Many of the difficulties associated with automation, however, can be avoided or minimized with appropriate planning and a careful assessment of current needs and specific goals. The experience of many developed and a growing number of developing countries, as well as the availability of technical assistance, can help a country make the transition from manual to computerized systems a successful one.

Sources of international assistance

A number of international agencies now offer technical assistance on data processing needs and equipment. These agencies include:

The International Monetary Fund, which responds to requests for technical assistance regarding electronic data processing in revenue administration. This is provided under the auspices of its Fiscal Affairs Department. The Fund is best able to respond to requests regarding the determination of what application of computer technology is most appropriate to a country's situation, and to study the feasibility of introducing or expanding computer systems. Advice has been given, for example, on the design and implementation of a taxpayer identification system, as a prelude to the design of a full taxpayer master file;

The Intergovernmental Bureau of Informatics, which promotes research and use of information sciences at the government level;

The Inter-American Center of Tax Administrators, which has developed training in ADP for tax officials from Central America and South America, with the cooperation of France, Germany, Spain, the Inter-American Development Bank, and other international organizations;

The Customs Cooperation Council, which is considering the development of guidelines on specific customs applications of computers. Demonstrations on the use of computers by customs administrations of Australia, Canada, Cameroon, China, the European Community, France, Tunisia, the United Kingdom, and the United States were organized under the auspices of the Customs Cooperation Council in June 1985;

UNCTAD, which has developed a project with the CEAO countries (see ASYCUDA box); and

The Organization of American States which, on a limited basis, provides technical assistance to its member countries on the computerization of their income, sales, and land taxes.

ASYCUDA

The Automatic System for Customs Data Acquisition, Control, and Management (ASYCUDA) was created and developed by UNCTAD experts to be used in a variety of ways in a customs office and at the customs department headquarters. The system functions on microcomputer equipment that can be expanded, particularly in terms of memory and the number of work and teletransmission stations. It can operate autonomously or under the control of a central plant.

Recently the ASYCUDA software system was adapted by UNCTAD/CEAO experts to implement, on the basis of standardized customs documents and codifications, the collection, acquisition, and control of information required by CEAO member countries for the calculation of compensation and the production of trade statistics. (Customs duties collected on trade within the CEAO feed a common fund; this fund compensates importing countries that have negotiated lower duties on goods for two thirds of the difference between the yield from these lower rates and the full rate.)

Given the mutual obligations of community members, the system is capable of processing all national or international data in accordance with the requirements of each country. The system also provides conformity of information, so that both community and individual member countries can be assured of the accuracy and authenticity of the data collected. Its flexibility also permits the creation of specific procedures in response to the community's demands.

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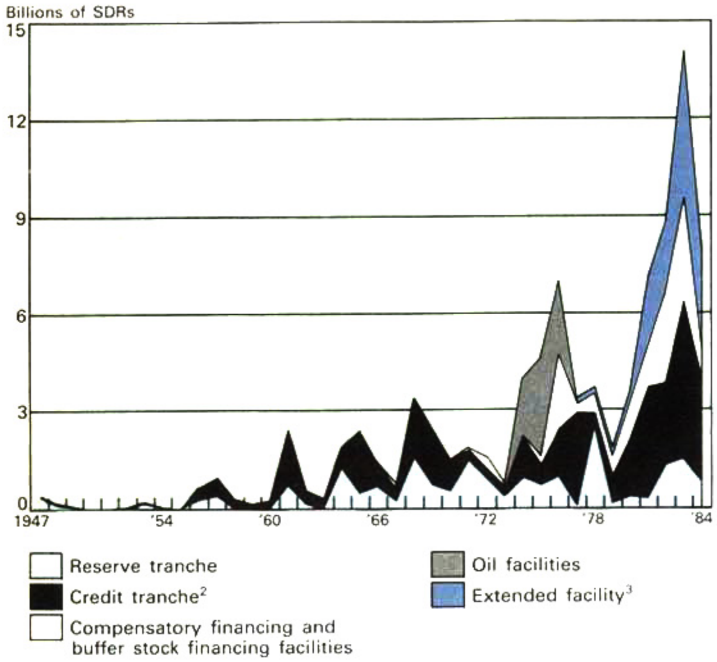
Fund and Bank lending, 1947–84

(Fund figures are given in calendar years; Bank figures in fiscal years.)

Chart 1

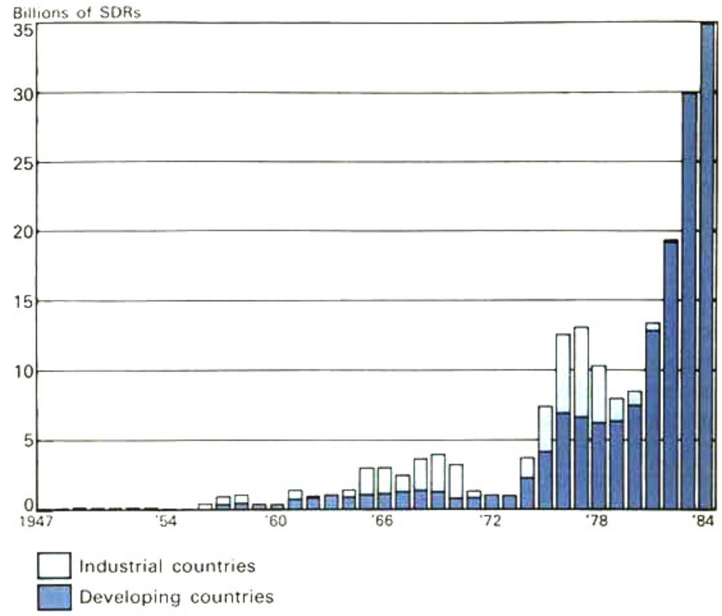
Total drawings on the Fund[1]



Source: IMF data.
[1]During period for all Fund members.
[2]Credit tranche includes supplementary financing facility and enlarged access resources.
[3]Extended facility includes supplementary financing facility and enlarged access resources.

Chart 2

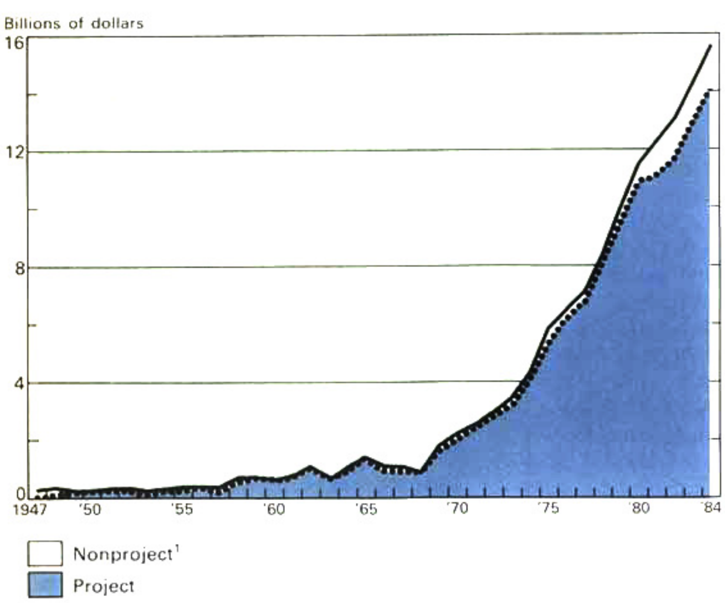
Use of Fund credit[1]



Source: IMF data.
[1]Outstanding amounts at end of period for all Fund members.

Chart 3

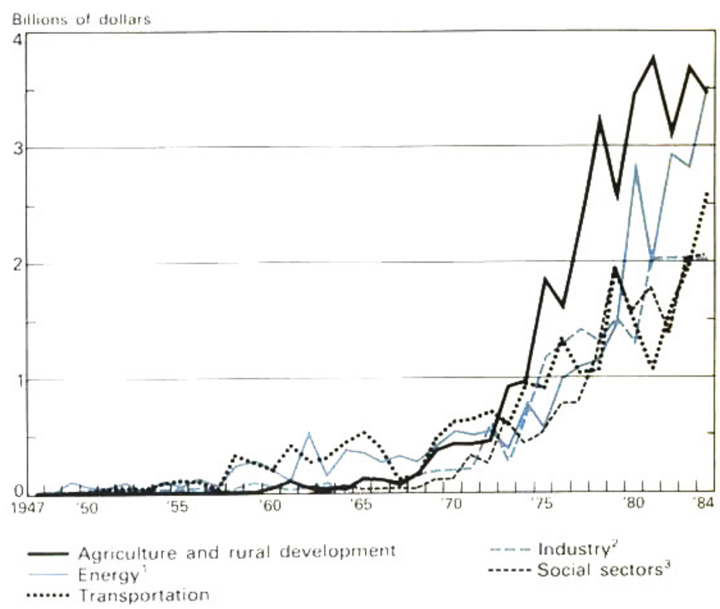
Total World Bank and IDA lending



Source: World Bank data.
[1]Includes program lending, structural adjustment lending, and multisectoral technical assistance loans and credits. Also includes sectoral adjustment lending not included elsewhere.

Chart 4

Selected World Bank and IDA lending, by sector



Source: World Bank data.
[1]Includes oil, gas, coal, and power.
[2]Also includes small-scale industry and development finance corporations.
[3]Includes education; population, health, and nutrition; water supply and sewerage; and urbanization.

Isher Judge Ahluwalia

Industrial Growth in India

Stagnation since the Mid-Sixties

New Delhi, Oxford University Press, 1985, xxii + 235 pp., Rs 120.

This very substantial and path-breaking book focuses on one of the major problems of present-day India—what went wrong with industrialization over the past three decades and what should be done to make industry more efficient. The author spares us from yet another set of algebraic equations that show ideal resource allocation in an ideal environment. She also does not attempt to justify what went wrong, be it by a low level of development, poor resource endowment, import protection by India's potential trading partners, or their unwillingness to share industrial technology. In preparing her book, she has combined the refinement and scrupulousness of a researcher, honesty, passion, and a thorough knowledge of sources of information and of ideas on Indian industry. The result is truly impressive.

India's manufacturing sector entered the post-Independence era with large promises. It could count on demand generated by a huge domestic market and could tap the vast domestic resources of cheap labor at all skill levels. Its private sector was led by business dynasties that had gained recognition and experience in the world of trade and technology. Its managers did not have to cope with linguistic barriers and could benefit from well-established contacts in major foreign industrial centers.

Yet the results of the succeeding decades were far from impressive. Growth rates in the industrial sector gradually declined from annual rates of 8 percent in the late 1950s to middle 1960s, to less than 6 percent during the 1970s, and to around 2 percent in the first years of the current decade. To determine the sources of this lackluster performance, reflected not only in declining growth rates but also in quality, design, productivity, and a relatively feeble contribution to exports, the author reviews critically most of the hypotheses that attempted to explain this slowdown as well as those that sought to quantify the negative aspects of Indian industrialization.

The author shows that the distribution of income in India has not worsened over time and cannot be held responsible for the slowdown. Furthermore, lagging agricultural output—translated into a suspected decline in agricultural incomes—has never, in fact, taken place and could not have had any effect on demand for industrial goods, especially considering that the slowdown of industrial growth occurred mainly in heavy industries.

She points instead to four factors that contributed to industrial stagnation in the last two decades: (1) slow growth of agricultural incomes in general, and therefore an absence of expanding—but not shrinking—demand for industrial goods in rural areas; (2) a slowdown in public investment, starting from the mid-1960s particularly in infrastructural investment; (3) poor management of infrastructure leading to severe infrastructural—mainly power and transport—constraints; and (4) the industrial policy framework, including both domestic industrial policies and trade policies, and their effect in creating a high-cost industrial production.

Interspersed within the author's analysis is a wealth of information, not only on Indian industry but also on some basic problems regarding industrial performance in LDCs, including the flaws in highly aggregated central planning and the insufficient attention given to forecasting market demand or to design specification, in particular in capital goods industries.

On the whole, the administrative limitations of the policy framework in Indian industry created strong incentives for "rent seeking." The system discouraged entrepreneurial innovation and induced speculation and maximization of short-term objectives. The industrial policy framework became more and more regulatory and less and less developmental, thus belying the original promise of "channeling" growth in desired directions. This leads the author to suggest that a review and overhaul of the industrial policy framework is in order.

It is worth noting, in fact, that this study appeared on the eve of important policy decisions by the new Government that are meant to free India from excessive reliance on bureaucratic controls.

Alexander Nowicki

Richard W. Edwards, Jr.

International Monetary Collaboration

Transnational Publishers, New York, 1985, xxiv + 822 pp., $85.

Postwar international monetary cooperation, conceived during the dark days of World War II and against the backdrop of the monetary chaos of the 1930s, made a remarkable contribution to world economic recovery and the expansion of international trade, in conditions of relative stability. The principal forum for collaboration was the IMF, and its cornerstone the par value system of exchange rates. The latter is no longer with us, overwhelmed by events long ago, but international economic cooperation is very much alive, and a crucial need in current circumstances.

This *magnum opus* provides a detailed, and highly readable, description of the framework, arrangements, procedures, provisions, instrumentalities, forums, and organization for international monetary collaboration. It is buttressed by a good deal of negotiating and legislative history and provides a comprehensive and informed account of international monetary law. It treats monetary cooperation in the widest possible context, covering virtually every form of cross-border financial relationship. "International" is not used only in the sense of universal or global; regional arrangements are also included.

This book, some dozen years in the making, is written primarily from the standpoint of an international lawyer who is interested in the legal and institutional framework of the international monetary system within which the political economist must work. As such, it should be of im-

mense benefit to anyone interested in international monetary relations—bankers, academics, journalists, and so on. It has been meticulously researched and the author has had access to much heretofore unpublished material. The result is a reliable, solid, and authoritative work of reference on this important topic.

While comprehensive on the framework and arrangements of international monetary collaboration, it does not attempt, in any deep analytical sense, to link the collaborative corpus to underlying economic issues or developments. Also, this reader missed an overall, analytical, summing up. International monetary collaboration is not an end in itself, but is intended to promote a better environment for international trade, an efficient allocation of resources, enhanced economic development, and, more generally, higher living standards all round. Against these criteria, how has the international monetary system performed?

In his preface, the author states that this book is "meant to be read from cover to cover"—presumably all 850 pages of it. Most readers are unlikely to do this, but will use it as a work of reference. Professor Edwards is to be congratulated for giving us this massive compendium. It is to be hoped that he will revise it periodically.

Bahram Nowzad

Centre d'Etudes Prospectives et d'Informations Internationales

Economie Mondiale 1980–1990

La Fracture?

Economica, Paris, 1984, x + 402 pp., F 150.

According to the Paris-based Centre d'Etudes Prospectives et d'Informations Internationales (CEPII), the world economy, or some of its regions, could face a severe new crisis. Seven potential disruptions ("fractures") receive particular attention: (1) the large public sector deficits in most industrial countries; (2) the high and often rising share of social transfers, which thwarts the process of adjustment policies; (3) the difficult changes in the structure of industries—required by shifts in relative prices and demand; (4) "the worrisome arithmetic of employment" when overall growth prospects are insufficient; (5) the low growth in real disposable income in socialist countries, where management of the economy remains principally a means of power (except to some extent in China); (6) the likely long-lasting reversal of past trends in energy markets, with developed countries—unlike most LDCs—having learned the lessons of two oil shocks; and (7) international indebtedness, complicated by restrictive monetary policies in most creditor countries. The concluding chapter argues that a monetary and financial knot binds all these problems together and disentanglement would require new and more effective answers than have been offered thus far.

Two compound fractures, as it were, receive special weight: unemployment in OECD countries, especially in Europe, and excessive indebtedness in a large number of developing countries. On both scores, the tone is rather pessimistic. With regard to the very high debt-service burden in LDCs, the CEPII stresses the strong balance of payments constraint on growth (the elasticity of manufactured goods imports is about 1.5 on average), concluding that the path of adjustment is both grim and narrow.

On the whole, CEPII's well-documented analyses are more convincing than its somewhat cautious projections, which are based mainly on model simulations. The IMF's *World Economic Outlook* (April 1985) presents a less gloomy picture but was, admittedly, published after the 1984 recovery in the United States. More fundamentally, however, I would ascribe CEPII's caution to the rather static reasoning used in the report. Adjustment policies should be construed not only in financial terms but also in terms of structural changes. Given a set of structural parameters, unemployment in Europe may decrease as growth speeds up, or as work-sharing schemes compress the effective labor force; however, it may also decline as a result of more flexible labor markets or through the development of labor-intensive sectors. Likewise, external imbalances can be reduced by slowing down the rate of growth or by containing imports, freeing resources to service external debts. However, a shift in policies, especially pricing policies, can result in export promotion and real import substitution (without heavier protection) and this may be a more efficient route.

Despite CEPII's somewhat backward looking econometrics, the book is truly worthwhile and stimulating in its examination of current and prospective problems in the world economy, and should be of great help for anyone studying economic fluctuations.

Philippe Beaugrand

John Whalley

Trade Liberalization Among Major World Trading Areas

The MIT Press, Cambridge, MA, USA, 1985, vii + 311 pp., $30.

Professor Whalley's book represents a much-needed attempt to apply theoretical precepts of trade policy to concrete policy questions. Which regions, for example, have gained most from the GATT-negotiated reductions in trade barriers and what are the prospects for further multilateral trade liberalization compared with the possibility of increasing fragmentation into bilateral arrangements? The answers depend upon the workings of a complex political decision-making process that, as Professor Whalley emphasizes, no model can adequately capture. Nevertheless, the significant contribution of this book is that it suggests a useful analytical framework for examining policy issues.

The author uses two numerical general-equilibrium models of the Heckscher-Ohlin type. The models serve to analyze and quantify the effects on different regions of changes in their own or their partners' protection policies—and to evaluate the potential worldwide gains from alternative trade liberalization initiatives.

Terms-of-trade effects are critical to the approach and the results obtained. A unilateral abolition of US tariffs, for example, produces a net welfare loss for the United States, since the terms-of-trade loss more than offsets the domestic welfare gain resulting from the liberalization. Tokyo Round tariff cuts are estimated to result in gains for the main industrial trading partners and losses for the rest of the world. These results, and other simulations in the book, run counter to suggestions that unilateral trade liberalization is generally desirable in both developed and developing countries.

The author's results hinge on four main points of methodology. The most important is the emphasis on terms-of-trade effects.

The other points are import-price elasticity estimates that are lower than some estimates elsewhere, an assumption of constant returns to scale in production, and a reliance on a comparative-static mode of analysis that precludes an estimation of benefits from trade liberalization that might derive from, for example, higher growth rates and increased economic efficiency.

In his concluding section Whalley rightly emphasizes the dangers of trade policy retaliation and stresses the positive role of the GATT as an accommodation-preserving process. His characterization, however, of the GATT as a "regional trade arrangement" that involves the developed North but all but excludes the South appears to be unjustified. A particular feature of the GATT is the principle of most-favored-nation treatment, which helps to protect the trade interests of smaller nations. The partial breakdown of this principle in the textiles and clothing sectors, and the proliferation of voluntary export restraints, have been at the expense of the developing countries. Although the author recognizes that, in these sectors, protection causes a terms-of-trade loss to developing countries, the models developed here do not fully take account of the bilateral, sector-specific nature of much of the "new protectionism."

S. J. Anjaria

C. H. Kirkpatrick, N. Lee, and F.I. Nixson

Industrial Structure and Policy in Less Developed Countries

Allen & Unwin, Winchester, MA, USA, 1984, xii + 263 pp., $29 (cloth), $11.95 (paper).

This well written and useful overview of industrial policy issues in developing countries ranges from topics of market structure and business organization to trade policies and policies toward multinational corporations. The book describes the literature and some of the experience gathered over the last two or three decades.

On most policy issues, such as the role of the public sector, the role of the multinationals, and export promotion versus import substitution, the authors take a middle-of-the-road position, organizing the pros and cons and giving a balanced economic analysis of the evidence. While this balanced, moderate approach is on the whole welcome, at times the reader longs for firmer conclusions; those expecting concrete policy recommendations may be quite disappointed. To take a somewhat extreme example, the section on "Finance for Industrial Development" concludes that "generalizations should not be made on the basis of such limited data. It is nevertheless worth pointing out that the dependence of individual firms on alternative sources of finance will vary between countries and over time, being influenced by the availability of funds from alternative sources, by government policy—both with respect to its attitudes toward private enterprise (domestic and foreign) and with respect to the provision of finance, and by the degree of political stability (or instability) in any country at any one time."

Because the argumentation is left quite open-ended and because the analysis does not get down to practical issues of policy design (for example, how to design a workable duty-drawback system for exporters), the book is more useful for those seeking a good survey of industrial development issues than for practitioners looking for concrete advice on how to conduct their business.

Kemal Dervis

Brian Griffiths and Geoffrey E. Wood (editors)

Monetarism in the United Kingdom

St. Martin's Press, New York, 1984, vi + 305 pp., $27.95.

This volume, published in 1984 but consisting of six discussion papers presented in a 1981 conference, is dated. In 1981, macroeconomic debate in the United Kingdom proceeded along traditional monetarist/Keynesian lines; reality since then has been more complex. The monetarist prophecy that the unemployment cost of disinflation would be short-lived has not been verified. Equally, the Keynesian prediction, that recovery could not commence without a policy U-turn, has not been borne out either. Structural factors in the labor market, especially the behavior of real wages, now receive more attention than three years ago—but the present volume has little to say on this.

The paper by T. Sargent and N. Wallace establishes that under certain conditions (in particular, when the real rate of interest exceeds the rate of growth), fiscal deficits may "cause" inflation. Specifically, a sustained fiscal deficit may ultimately force monetary authorities to resort to monetary financing, for beyond a certain point the public will be unwilling to hold additional bonds.

A. Budd *et. al.* argue that "monetarism fits the facts" in the United Kingdom, in the sense that the demand for money is stable, and changes in the quantity of money (sterling M_3) have been an independent source of changes in prices. While their paper contains much valuable information, the exposition is confusing; the criteria used in sifting the evidence are by no means clear, and the approach to causation is fuzzy.

R. Batchelor's paper seeks to explain high levels of unemployment in the United Kingdom in a "natural rate" context. Unfortunately, the explanation is flawed—one major determinant of the natural rate of unemployment in this paper is a dummy variable, equal to zero before the current Government and one thereafter. This appears to "explain" about 2 percentage points of the increase in unemployment.

J. Kay's work covers familiar territory in its look at the effect of North Sea oil in a tradable/nontradable model, while Aliber sheds little light on how much of the real appreciation of sterling up to mid-1981 was a result of tight money and how much caused by North Sea oil.

The final paper, by A. Bade and M. Parkin, asks which monetary aggregate should be targeted. What makes this paper truly astonishing is the contrast between the initial and final versions. At the conference, the authors favored "pursuit of a steadier and smoother growth of the monetary base," while in the published version, they favored "pursuit of steadier and smoother growth of £M_3." In another 1981 paper by Parkin, apparently M_1 was the the preferred aggregate. Had the authorities been following the twists and turns of this advice, their credibility would have been in shreds.

In sum, several of the papers are of poor quality and the publication lag reduces the relevance and timeliness of the others. Recommended only for those with large book budgets.

Owen Evans

Dale W. Adams, Douglas H. Graham, J.D. Von Pischke (editors)

Undermining Rural Development with Cheap Credit

Westview Press, Boulder, CO, USA, 1984, xi + 318 pp., $25.

The results of agricultural credit programs have come under increasing scrutiny in recent years. A group based at Ohio State University has been in the forefront of studies on the subject and this collection of papers has been edited by two of its members, Dale Adams and Douglas Graham, and by J.D. Von Pischke of the World Bank.

The study's principal concern is that many agricultural credit programs have not benefited agriculture and the smaller farmers in developing countries as expected. Their primary thesis is that the provision of cheap credit is the principal reason for the poor results. Governments have often tried to assist small farmers by providing low interest rate loans and they have done so to promote equity, to reduce the costs of producing local food or export crops, and to build political goodwill.

Various authors examine specific country experiences, but the general consensus is that low interest rates prompt larger farmers to capture most of the credit at the expense of smaller farmers, reduce rural investment from local resources, divert low interest funds to nonrural activities, substitute loans for borrowers' own funds, and reduce opportunities to mobilize savings. Low interest rates also encourage the establishment of specialized financial institutions, most of which have significant problems with overdue loans, solvency, and effectiveness. The book argues, too, that deposit mobilization is a necessary corollary to effective lending.

This book is written basically for those with an interest in the subject. There is some repetition, a difficult feature to overcome in a collection like this, but the overview articles and the use of conclusions or policy implications at the end of each article make it possible for the more casual reader to skim the material and pick up its main points. Some might criticize the book's heavy emphasis on Latin America, but this partly reflects the fact that most of the spectacular cases of credit distortions have occurred in this region and the principles cited are generally applicable elsewhere.

The book is a must for all those working with credit, whether rural or industrial, and certainly worth an hour or two for anyone concerned with agriculture. The criticism of the international agencies calls for thought by those concerned with formulating and implementing agricultural and credit programs.

D. Brian Argyle

G.S. Kindra (editor)

Marketing in Developing Countries

Croom Helm, Kent, UK, 1984, xii + 259 pp., £19.95.

This collection of 14 well-written articles provides a useful perspective on the role of marketing in the process of economic development. The book attempts to make a case for the stimulative role that a well-conceived marketing system can play and identifies the factors that should be considered in developing a marketing system that enhances economic and social progress. In combining articles written by authors with diverse social backgrounds and development perspectives, Kindra demonstrates how various elements of marketing interact to stimulate economic growth. By stressing the importance of marketing in the process of economic development, the book attempts to dispel the image of marketing as a parasitic and socially irrelevant economic activity, a notion allegedly held by some development economists, both theorists and planners.

The diverse experience of the authors and the broad definitions adopted for economic development and marketing are also, however, serious weaknesses in the book. Economic development is defined as "something associated with increases in per capita income and social advancements." Similarly, marketing is "the network through which information can flow among the various actors in an economy to promote interrelated activities necessary to produce the final consumer products to satisfy societies' needs." In other words, marketing refers to the entire physical and institutional complex that generates those economic activities that link production and consumption. Given such broad and vague definitions for the two central concepts in the book and the diversity in the sociocultural background of the authors, it is not clear how or if the authors share a common understanding of economic development and marketing.

Nonetheless, the basic theme of the book is of special interest to those involved in the process of economic development. It can serve as a useful book of readings in economic development for students as well as for practitioners in development institutions.

Woldai Futur

Michael Skully (editor)

Financial Institutions and Markets in Southeast Asia

A Study of Brunei, Indonesia, Malaysia, Philippines, Singapore, and Thailand

St. Martin's Press, New York, 1984, xviii + 411 pp., $29.95.

This useful introduction to Southeast Asian financial institutions contains a short, but thorough, discussion of the functions of each type of financial intermediary, ranging from commercial banks to pawnshops. Individual firms within sectors are listed, often together with statistics on their assets and liabilities. Unfortunately, owing to the rapid evolution of the markets in these countries, some of the information is already out of date. The usefulness of this book would be enhanced if it could be updated annually.

Arnold C. Harberger (editor)

World Economic Growth

Case Studies of Developed and Developing Nations

Institute for Contemporary Studies Press, San Francisco, 1984, xii + 508 pp., $9.95.

This conference volume attempts to delineate and explain the underlying causes of economic "miracles" in some developing countries and the stagnation and decline in other LDCs and selected developed countries. Experts examine different phases in the economic history of individual countries. The aim is to shed light on the association between economic policy and growth. The developed economies studied include the United Kingdom, Japan, Sweden, Germany, and the United States. Developing economies include Tanzania, Ghana, Indonesia, Jamaica, Taiwan Province of China, Mexico, and Uruguay. Anne O. Krueger presents a broad review of trade liberalization, and Harberger rounds off the book with a summary of the main lessons. While "it must yield to other forces and pressures, successful policy will find ways to minimize the sacrifice or compromise of sound economic objectives. . . ."

The review of *Intergovernmental Finance in Colombia* (June 1985) erroneously referred to the book's authors as Harvard consultants. They are not.

Peter B. Kenan

The International Economy

Prentice-Hall, Inc., Englewood Cliffs, NJ, USA, 1985, viii + 552 pp., $29.95.

This is an excellent textbook for undergraduates. It adopts a straightforward, logical approach to the subject and is written in the clear, lucid prose we have come to expect from Professor Kenan. The presentation is attractive without being fancy; the algebra is kept within bounds while greater use is made of diagrams. In economics, perhaps more so than in other disciplines, textbooks must be up-to-date and reflect the evolution of theory as well as changes in fundamental conditions. Against this test, also, the book succeeds: while covering all the basics of international economics, it has a clear and up-to-date exposition of recent international economic issues (events as late as 1983 are included). To retain its freshness and value, the book will have to be updated every few years.

Béla Kádár

Structural Changes in the World Economy

St. Martin's Press, New York, 1984, 287 pp., $25.

This book focuses on the acceleration of structural transformation in the world economy that occurred during the 1970s. The author reviews developments in manufacturing industries, international trade, capital exports, the power structure of the world economy, and changes in North-South and East-West relationships, with further consideration given to the implications of the emergence of the oil-producing countries as important actors on the world scene. He also analyzes the policy implications of these changes, seeing the principal tasks of policy makers in the promotion of structural transformation for economic growth and the adaptation of national economies to the exigencies of an interdependent world economy. The book should be of interest to people concerned with international economic policy.

Robert F. Gorman (editor)

Private Voluntary Organizations as Agents of Development

Westview Press, Boulder, CO, USA, 1984, xii + 263 pp., $22.50.

Serious literature on private voluntary organizations and development is very scarce despite the importance of their work in the Third World and the size of their capital transfers to developing countries—$2.3 billion a year in grant form. This collection of articles provides a welcome contribution to a more rigorous and comprehensive understanding of the subject by government agencies, international institutions, and development scholars. Individual nongovernmental organizations may also benefit from an overview of the issues that confront their community as a group. Of particular significance is Larry Minear's lead article, "Reflection on Development Policy: A View from the Private Sector," and the discussion of nongovernmental organizations and the basic needs approach to development by the book's editor.

LETTERS

Expatriate workers

Naiem Sherbiny's article, "Expatriate labor in Arab oil-producing countries" (December 1984) is a good example of methodical, precise work. But I have some thoughts on the conclusions.

The underlying data for the analysis are based on 1980. The projections for immigrant foreign labor to selected Arab oil exporters are based on the medium-growth scenario of non-oil GDP. Given the perceptibly reduced oil production and reduced growth rates since the base year, the projections for immigrant foreign labor seem exaggerated. This thought is confirmed particularly by the now-published Fourth Development Plan of Saudi Arabia (1985–90), which forecasts a reduction in foreign labor of about 600,000.

Since Sherbiny did his analysis for three growth scenarios, the discussion of the implications of the low-growth scenario (in a later article?) could be useful.

Dr. Eckhard Freyer
University of Bonn

Naiem Sherbiny responds:
Recent developments in the Arab oil economies were factored in the projection exercise and the article's point, therefore, remains valid: the slowdown of economic growth is unlikely to reduce the stock of expatriate workers.

Moving targets

Paul Streeten's article on development economics in the June 1985 issue is a salutary reminder of a neglected economic truth—there is a problem to every solution. But is it meaningful to pose the paradox quite this way? Problems of efficiency and equity—a pertinent distinction not drawn by Streeten—arise precisely because there are no once-and-for-all solutions in a dynamic universe of risk and uncertainty. The policy maker has to learn to shoot at moving targets. Therefore, what the "doer" seeks are not unique equilibrium solutions but a flexible problem-solving capability to cope with persistent and unforeseen disequilibria. Thus, illustratively, in coping with a balance of payments problem (deficit) what the authorities aim at is not a neat accounting balance (or surplus) but a generally sustainable balance of payments position, that is, one which can be sustained by normal capital inflows and without resort to controls. Perhaps the last word should rest with a doer. "In the real world there is no such thing as an unmitigated good and an unmitigated evil. Each action has its own counterpart." (Ghulam Ishaq Khan, Chairman of the Development Committee, interviewed in *Finance & Development*, June 1985).

Anand G. Chandavarkar
IMF

African problems, African solutions

Regarding the World Bank's third report on Sub-Saharan Africa, excerpted in your December 1984 issue, I do agree with two of its points: (1) national rehabilitation and development programs must be designed and implemented to increase the efficiency with which financial and human resources are used, and (2) there must be a more active role for nongovernmental institutions and the private sector.

While these points are part of the essential solutions, the main answer has been neglected. Failure to develop "appropriate technology" is the main cause of Africa's problems, since a large part of its workforce resides in rural areas.

We (the Young African Scientists and Engineers, Overseas) have been calling for an "International Conference on Appropriate Technology" for Africa. We also believe the World Bank should provide financial support and interest-free loans for firms and organizations developing appropriate technology.

We can solve Africa's economic problems by increasing production. If Africa is unable to feed itself, however, no development of any kind can be achieved.

M. Ade Iman
Istanbul, Turkey