

The AID Economists' Conference

PAPERS AND PROCEEDINGS

Annapolis, Maryland
November 4 - 8, 1984

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OF
THE AID ECONOMISTS' CONFERENCE

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The views expressed in this volume are the authors' and participants' own and do not necessarily reflect the policies of their agencies. The views and interpretations concerning economists in the Agency for International Development are intended as commentary to stimulate further discussion.

PREFACE

This report provides a record of the first Agency-wide conference of AID economists to be held in the institution's 25-year history. The Conference occurred because several individuals in AID exercised their initiative and devoted appreciable time and effort to make it happen. The prime mover was M. Peter McPherson who perceived the need for more and better economic analysis capability in AID and instructed the Agency to take a series of measures to achieve this objective. Holding a conference of AID economists was one part of the overall effort. Richard Derham and Fredrick Schieck were instrumental in supporting efforts to plan and to finance the cost of the Conference. AID Mission Directors and Bureau Associate Administrators supported the undertaking by authorizing financing of travel and per diem expenses for their Conference participants and these same managers incurred what we assume to have been the nearly intolerable opportunity costs of having their economists absent for the week. Kenneth Kauffman helped in planning during the final preparation phase and skillfully led many of the Conference sessions.

The details of the Conference were worked out by a steering committee composed of Jim Fox, Mike Crosswell, Mike Farbman, Ben Severn, Jerry Wolgin, Jim Elliott, Len Rosenberg and Jim Mudge who served as chairman. Jennifer Collins assembled the microcomputer workshop which also benefited from contributions by Richard Collins. The Pragma Corporation in the persons of Jacques Defay, Carol Pearson, Galen Hull, and Maggie Chadwick demonstrated great skill and ingenuity in making preparations for the Conference, finding the Annapolis location, making logistical arrangements and insuring that vital ingredients were mixed in at the right times and places during the Conference.

The Conference was greatly enriched by the participation of many individuals in addition to the AID economists. Some of these individuals were Arnold Harberger of the University of Chicago, Hans Gerhard of the IMF, as well as Luis de Azcarate and Alex Meeraus of the IBRD. Important contributions were also made by John Eriksson, Szabolcs Szekeris, Gene Ellis, Robert Muscat, James Feaster, and Catherine Gleason. The core substance of the Conference was the AID economists themselves who provided their expertise and extensive first-hand experience in the topics under discussion as well as a lively curiosity and willingness to learn from others. The whole circus was propelled by the panel moderators, rapporteurs and

discussants. This group worked hard with little advance notice to prepare all sorts of papers, models and templates. Finally, we would like to extend special recognition to Sam Skogstad and his straight person, Maureen Lewis, without whom we may have gone through life without knowing the translation of V.C.I.

This Report was assembled by Pragma staff with the aforementioned Conference Committee serving as the editorial board. Mike Crosswell made major contributions to organization and editing. Jim Mudge, with the assistance of Warrior Richardson, prepared the questionnaire survey summaries.

Jim Mudge
September 19, 1985

AID ECONOMISTS' CONFERENCE
ANNAPOLIS, MARYLAND
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SECTION ONE:

**OVERVIEW, KEYNOTE ADDRESS,
AND CONFERENCE RECOMMENDATIONS**

**Robert Muscat
and
The Conference Steering Committee**

Arnold Harberger

AID Economists' Conference Overview

by Robert Muscat and the Conference Steering Committee

Introduction

The conference held in Annapolis on November 4-9, 1984 was probably the first such gathering in the agency's twenty five year history. Around 175 economists attended from both Washington and the field. Outside participants included World Bank, IMF, and IDB representatives among others. Professor Arnold C. Harberger, from the University of Chicago was also a participant and the keynote speaker.

The conference began with a dinner on Sunday and an address by Frank Kimball, Counselor to the Agency. The opening session on Monday was led off by Kenneth Kauffman, Director, Office of Economic Affairs. The subject was Economic Stabilization, Structural Adjustment, and Long Term Development: Implications for AID programs. Monday afternoon and Tuesday morning were devoted to the subject of policy dialogue. Since policy dialogue between AID and host governments often has focused on stabilization and structural adjustment, the first day and a half formed one unit of discussion and are so treated in these introductory notes. By breaking into four panel groups on Monday afternoon, the participants had greater scope for individual participation. Professor Harberger gave the keynote address Monday evening.

On Tuesday afternoon there were sessions on economic analysis in the Agency's country planning process and on the use of economic models. Both subjects related to the earlier macro policy discussion. The Wednesday sessions on project analysis were also divided into panel groups with plenary session to review panel recommendations. Three evening workshops were held on uses of micro computers in AID economic work.

The conference turned on Thursday morning to consider the role of economists in AID from both substantive and personnel aspects. On Thursday afternoon and Friday morning the conference divided into regional groups to discuss specific topics of interest to particular regional bureaus. The conference closed Friday afternoon after a plenary session for summary and discussion of recommendations.

Jim Mudge, PPC/EA, was responsible for conference planning, assisted by a small group of economists representing the regional bureaus. Pragma Corporation handled all administrative arrangements, housing, and conference facilities.

Background to the Conference

The conference was held at a time when AID attention to economic policy issues is again high, after a number of years of focus on project-level and micro processes. The narrower attention of much of the 1970s itself had been a reaction against the macro-level emphasis of the 1960s. Dissatisfaction with the perceived effects of overall economic growth on the distribution of income and the apparently limited participation of the poor in the development process had led to a shift in program and policy content in AID's activities, in favor of more targeted projects designed to have a relatively direct, immediate and verifiable impact on the poor. The Agency's attention to economic policy issues gradually diminished during the 1970s. With shrinking need for economic analysis in these areas, the number of economists in AID also declined.

The pendulum began to swing back in the late 1970s. The effects of the second oil shock, the emergence of over-arching structural adjustment programs, and the recognition that fundamental policy problems aggravated by exogenous factors such as the weather lay at the heart of the downward drift of Sub-Saharan Africa, led AID (and other donors) back to the importance of the overall policy framework. There was mounting recognition of the importance of economic growth as both a necessary and sufficient condition for poverty alleviation in low-income countries, as well as increased appreciation of the harmony between efficiency and equity concerns.

The content of the 1980s policy focus has some new features compared with the 1960s. For one thing, the record of a number of countries in the intervening years (e.g. the East Asian success stories), and the substantial body of research that had been produced (including a number of major studies under financing from AID's Bureau of Program and Policy Coordination) on the import substitution strategies that dominated the 1950s-1960s, provided powerful evidence for the advocates of trade liberalization and reduced government intervention in market prices and resource allocation. For another, the now long record of inefficiency and fiscal drag from public sector economic enterprises appeared so exposed and incontrovertible that

ideological considerations began to give way under the urgent need for more effective growth strategies. The advisability of enforcing tough fiscal discipline on public sector enterprises, or even better of dismantling them or selling them off to the private sector, became widely accepted and an important aspect of structural adjustment programs.

AID has played a more active role in the renewed policy dialogue than most other bilateral donors. To help carry out such dialogue, the Agency found it useful to rebuild its economics capabilities and to reexamine its positions on a number of economic questions. Needless to say, the revival of interest in general policy dialogue has also had implications for program content, for AID mission staffing and responsibilities, and for the style and substance of AID's relationships with governments.

The Annapolis conference was an occasion for some stock-taking on all this by the professional economists whose work helps inform and support Mission Directors and agency senior management. Besides the working papers prepared in advance for the conference, this volume summarizes the proceedings. This introductory essay attempts to record the issues, salient views, and general drift of opinion where such existed. The synthesizers have the advantage of having the last word; under the necessity of putting prepared papers and spontaneous exchanges (including those in concurrently run panel sessions) into a coherent summary, we will exercise that advantage by rounding out with some observations not actually made at the conference.

Stabilization, Structural Adjustment and Policy Dialogue

The conference began with presentations by Hans Gerhard and Luis de Azcarate on the approaches of the IMF and World Bank, respectively, to stabilization and structural adjustment. As in his paper, Gerhard gave a succinct description of the common elements of stabilization programs and of the methodology used by the Fund to define the key policy variables, their relationships, and the possible configurations of a set of consistent targets. He also briefly scanned the results of the IMF's experiences in the past few years with stabilization programs with developing countries.

Gerhard noted that although the same methodological framework is used in all country cases, and structural maladjustment situations have a lot in common, the IMF staff

apply the monetary accounting methodology flexibly to suit local circumstances; the number of policy variables affecting domestic prices and the external accounts is sufficient to allow considerable scope for governments to shape alternative policy packages to achieve the desired stabilization results. He also stressed that IMF fiscal and monetary targets were not used mechanically to determine or automatically test whether a country was in violation of an agreement. Instead, failure to meet one or more tests was treated as a "warning bell" to bring country and Fund attention to the need to reexamine performance and circumstances. Performance under stabilization programs has varied widely.

As described by de Azcarate, IBRD Structural Adjustment Loans (SALs) normally are closely complementary to Fund stabilization programs, if not overlapping in some areas. The time frame of SAL programs is longer than that of Fund agreements, while the content covers structural problems pertaining to policies and institutions, and changes required to sustain the stabilization objectives to be attained under Fund agreements. In contrast with the IMF's relatively narrow statutory responsibilities and time frame, IBRD structural adjustment programs focus on sustainable growth, rather than just stabilization. SAL programs typically cover incentive structures (prices, tariffs, taxes and subsidies), public sector investment priorities, budget and external debt management, and institutional strengthening, especially public enterprise managements. SALs comprise less than 10% of overall IBRD loan operations.

The implications of stabilization and SAL programs for AID were summarized by Stu Callison. We should note, by way of introduction, that nearly 60 LDCs had stabilization program agreements with the Fund in 1982-84, 16 had SAL programs with the World Bank, four of which have been discontinued, while a few other countries in the same period had non-project loans from IBRD that were not SALs strictly speaking but that did involve policy dialogue. Thus a significant number of countries receiving AID assistance were operating within policy adjustment frameworks having major impact on bilateral donor activities. Much of the week's discussions and many of the papers prepared for the conference (and reproduced in this volume) provided rich detail on individual country experience, different roles AID had played in these environments, and the issues AID faces, especially where the agency is itself involved in the adjustment policy dialogue process.

Callison's paper is a logical point of departure. He briefly sketches out the implications for AID and describes the congruence between policies required for structural adjustment and those needed for an equity-oriented growth strategy. To the extent this congruence prevails in any actual case, AID's views on the desirable direction of economic policies and institutional strengthening would coincide with those of the IMF and the IBRD. An AID mission would not find itself squeezed between the development objectives of AID's legislation and the immediate needs for economic policy reforms to raise economic efficiency, restore external balance and reestablish conditions for sustainable economic growth. Callison gives us a useful list of all categories of distortions, not that any actual case would likely comprise a "complete cookbook" of anti-neo-classical, disequilibrating policies and government interventions.

Bob Rucker's paper gives a brief account of the Indonesian case and the many elements it contained that are found in the structural programs of numerous countries. In the Indonesian case, the macro-economic issues set the framework within which the USAID program has been working. But AID's activities, its projects and attendant dialogue, have been at the sector and sub-sector level, with no effort to participate in structural adjustment discussion or negotiation beyond US participation in Indonesia's donor coordinating group.

The Indonesian case was exemplary in some respects. While adjustment was delayed until a virtual crisis was approaching the Indonesian economy, a well-designed set of policy reforms was initiated vigorously and supported strongly at the political level. The role of AID in Indonesia for a number of years, leaving macro-policy dialogue to the IFIs and technical policy assistance to economists from the Harvard Institute of International Development (HIID), did not need to be changed. Contrasting situations were described by Greene (Kenya), Zuvekas (Central America), Toh (Niger), Smith (Morocco), Adler (Costa Rica), Mulligan (Pakistan), Winch (Sudan), Dod (Egypt), Davis (Philippines), LaPittus (Honduras), de Merode (Mali), and Van der Veen (Bangladesh). In these (and other) cases AID has played a variety of roles with rather different kinds of technocratic and political, formal and informal dialogues, ranging from professional and collegial policy discussion generated by economic model-building exercises, to informal sector-level dialogue in connection with sector projects or CIP programs, formal sectoral conditioning of AID loans sometimes linked to issues under

IMF or IBRD dialogue, to formal negotiation over macro-policy.

Returning to the initial point regarding congruence between the IMF, IBRD and AID perspectives and mandates, the discussion and papers brought out several differences. AID seldom suspends programs for non-performance on policy understandings, although it may delay disbursements. AID's perspective is longer-term, and therefore emphasizes growth, compared with the IMF's concern with stabilization. A bilateral aid program has foreign policy or political objectives, for example, in the areas of equity and human rights, that are not present to add additional operating complexities to the work of the IMF and IBRD (at least, not to the same extent). In short, AID's objectives and constraints are more numerous, varied, complex, and sometimes more conflicting, compared with those of the IMF/IBRD.

With respect to broad economic issues, the basic goals, framework, and methodology of Fund stabilization programs were not challenged by AID economists. There was general acceptance of the genuine need for stabilization in countries with Fund programs, and with the basic economic logic of these programs. In particular, while stabilization might coincide with declines in growth, it was understood to be a necessary condition for a country to resume growth on a sustainable basis. Thus, there was a basic complementarity between Fund concerns with stabilization, and AID/IBRD concerns with sustainable growth.

At the same time, implementation of stabilization programs raises several issues for AID. First, stabilization programs necessarily call for fiscal and monetary restraint, and an improved balance between exports and imports. Governments make choices about how to achieve this--which expenditures and subsidies to cut; which taxes and fees to raise; where the burden of reduced imports should fall; etc. Since stabilization is politically difficult, these choices often reflect political considerations, at the expense of developmental and equity considerations that are of concern to AID. For instance, recurrent cost expenditures and/or programs that benefit the poor may be cut, rather than other expenditures with less merit in AID's view. The IMF is not oblivious to these concerns, and will offer views to the government on the costs and benefits of alternative packages of restrictive measures. Beyond this, there is some scope for AID programs and policy dialogue to affect the composition of expenditures, revenues, credit expansion, and imports.

Second, the severity of any particular adjustment program depends on the magnitude of the adjustment problem (e.g., how large a change in the current account deficit) and the time span over which adjustment needs to take place. An economic issue arises if the IMF program is more severe than necessary to achieve the required adjustment in the required time span, or if the required adjustment is misestimated. A political issue arises if the program is economically sound, but politically unfeasible. In either case, one solution is to provide additional concessional assistance, or assistance in more fungible form, such as non-project instead of project assistance. This can reduce the magnitude of the adjustment problem, lengthen the time over which adjustment must take place and/or alleviate some of the political costs associated with stabilization.

Both the economics and politics of short, sharp adjustment versus gradual incremental change came up repeatedly as experiences in different countries were reviewed. While the politics of some countries may require the short, sharp adjustment as the only way to finesse the resistance of vested interests that would otherwise have time to mobilize effective blocking tactics, the politics of other situations has demonstrated the greater local feasibility of incremental policy changes, with each step having impact below some threshold at which strong if not violent reaction would be generated. Such finesse is easier if its expression of anxiety over that threshold might be a negotiating tactic. But a resident observer may be expected to have a better basis for judging the sharp versus incremental feasibilities than the observer from institutions operating mainly out of headquarters.

Rucker describes the case of Indonesian policy changes in 1983, an example of a "short sharp adjustment". Other countries lacking an experienced economic policy team, with similar well-established relationships with political authorities of long tenure, may not be able to design and implement rapid changes in policy. Based on its African experiences for example, the World Bank has been drawing the lesson that the viability of structural adjustment processes often depends on properly paced phasing. The efficient minimum time profile for a structural adjustment has proven in some cases to be rather longer than expected, political considerations aside, because of the time required to design policy details (e.g., revised tariff schedules) and the slower capability of institutions, government agencies and industries to adjust to changing rules of the game. There is an important lesson in this for any bilateral donor that is a serious SAL participant.

In sum, attendees agreed that any adjustment program would have to fit the particular circumstances, and that the degree of incrementalism in programs needed critical attention, noting that in any case delay in initiating adjustment measures carried a high cost. But if it is important to achieve optimal timing for the viability of structural adjustment programs and to avoid excessive contraction and hardship, are AID missions staffed to be able to identify such situations?

A second set of questions concerns external resources. As noted above, in most LDCs liberalization is likely to be reflected in export growth only after some lag. A donor should be prepared to help support liberalization with a sufficient level of concessional aid, for assured periods of time, to make it viable. US policies regarding Fund resources, IBRD resources, and US bilateral funds and multi-year commitments are obviously pertinent to US policy dialogue regarding structural adjustment.

Some of the practical difficulties field missions have in developing positions congruent with the IMF and IBRD (usually the major financiers by far) were also discussed. The different roles of State and Treasury, and sometimes USDA and other departments, sometimes make it difficult to develop a consistent US position. Several of the mission economists reported that communication with visiting IMF teams was often poor. Even where this is not the case, there is clearly a need for AID/Washington to improve communication between its own field missions and IMF and (occasionally) IBRD. (One interesting exception was in Niger where the mission economist, because of his professional and country expertise, developed an excellent working relationship with visiting IFI personnel to the point where IFI economists incorporated some of the AID economist's work into their papers.) It was observed also that AID is often one among a number of donors providing resources relatively small in relation to the IMF or IBRD. While some mention was made of the need for coordination with other bilateral donors, the formal structures for multilateral policy dialogue with individual LDCs--consortia, consultative groups, the Round Tables for least developed countries--were overlooked at this conference, perhaps a reflection of the declining role of these groups for purposes of real give and take on policy.

Policy Content

The actual policy content of a number of structural

adjustment cases, and the policy agenda between the US and the countries in question, is described in the papers in this volume. Although these papers were not written for professional journal publication (with all that implies for completeness, footnotes, and nuancing of language), they comprise a perhaps unique collection of informed descriptions and frank comment on what is likely to be in retrospect a watershed period for a large group of developing countries.

The details, emphasis, institutional aspects and politics of these cases differ of course, but the policy prescriptions negotiated share a common direction and a common set of assumptions about economic behavior and the determinants of economic efficiency under LDC conditions. This commonality (issues over timing and magnitude of short run adjustment aside) is worth stressing. In contrast with the divisions among economists over efficient growth policies in the OECD economies and the general decline in public confidence in the dismal science, development economists appear to retain a high degree of confidence in the prevailing analyses and policy prescriptions.

The general objective has been to move toward greater reliance on the market system for resource allocation, and toward greater efficiency in the operation of that market. In his keynote address, Harberger lists the key lessons learned over three decades of post-war LDC experience. Some of these lessons underlie the policy dialogue and direction of reform in the cases discussed at the conference, e.g., control budget processes in order to control deficits; retain control over inflation; maintain an open economy; rationalize trade restrictions; if politics constrain dismantling of import distortions, offset them on the export side; make the tax system neutral and easy to administer, and avoid excessive tax incentives; avoid price and wage controls; reduce interventions in the form of quotas, licenses and similar quantitative restrictions; allow (require!) public enterprises to behave like private ones, i.e., recover costs, pay market prices for inputs, take tough decisions on production and employment. Harberger might also have noted that administrative discretion over licenses, incentives, exemptions, etc., often leads to widespread corruption, a category of market distortion with very invidious potential.

Scanning the array of specific subjects included in AID policy dialogue in countries in different regions of the world, one gets some impressions of their local origins and logic aside from the professional consensus Prof. Harberger

cites, i.e., complementarities with stabilization and structural adjustment programs; continuity with AID's long-standing emphasis on and experience with agriculture; identification of local distortions of major significance (e.g., energy prices); market orientation and divestiture of public sector enterprises.

There is, however the problem of many Sub-Saharan Africa countries, where the time frames of both short-term IMF stabilization and medium-term structural adjustment are clearly inadequate for setting their economies back on a path of stable sustained growth. Both IMF stabilization "failures" and poor SAL performers cluster in this region. The underlying structural problems are apparently too profound for short-to-medium medicine to cure: small economies, vast population movements, political instabilities, agricultural and health problems only beginning to be addressed with modern scientific methods, small cadres of highly trained scientific and managerial personnel, etc. While there were no general discussions of regional characteristics and their impact on structural adjustment and the content of policy dialogue, it was observed that much larger volumes of concessional aid would be required for some years to address these underlying problems.

Another point on timing concerns the realism of medium-term targets. Flexibility in stabilization targeting was felt to be particularly important, especially in view of the economist's inability to make robust forecasts of the key variables that define stabilization programs. A recommendation was drafted that targets be reviewed annually for possible adjustment, and that specific targets be set only one year in advance.

Finally, professional agreement over the general direction of good policy does not guarantee agreement on specifics. David Dod gave a striking example of conflicting policy advice in Egypt. Studies by USDA, IBRD, and IFPRI have recommended different crop patterns with different preferences for emphasizing export crops versus grain production to substitute for imported grain.

The Dialogue Process

As the proceedings moved from discussion of the substance of stabilization and structural adjustment to the process of dialogue over that substance, it became evident that bilateral policy dialogue poses more complex problems, and takes more forms, than for either the IMF or IBRD.

Neither Fund nor Bank programs are always successful of course. There have been cases where stand-by agreements have fallen apart and where SAL programs have been discontinued because of non-performance that could not be renegotiated. The tenor of the conference discussions would lead one to conclude (although no actual "scores" were racked up to make such comparisons) that agreements negotiated by AID for the US bilaterally have had a lower success rate than was the case for the IFIs. This should not be a surprising conclusion for reasons spelled out in the papers and discussions.

Several difficulties face the bilateral dialogue process. For example, there is no simple correlation between size of economic aid (or degree of concessionality, or even between aid volume in relation to a recipient's imports or any other economic magnitudes) and AID's scope for dialogue. Nor does aid volume correlate with leverage where significant disagreements exist or where performance falls significantly short of formal understandings. (Implicit in the discussions were distinctions between dialogue--an exchange that leads to agreement by the recipient that certain policy changes are in the country's own interest; leverage--use of incentives or disincentives to influence a recipient to undertake policy changes, even if reluctantly; and conditionality--formal performance requirements serving as instruments of "leverage.") The distinctions are not sharp in practice. Formal conditions may be negotiated amicably and used by governments to help carry through policy changes inimical to particular domestic vested interests.

The largest economic aid programs quite naturally reflect major bilateral foreign policy interests. Conditionality respecting economic policies apparently has not been credible in such situations, and in fact has been either not attempted or not exercised in the event. Foreign policy considerations will normally overrule economic performance considerations. To provide AID's policy dialogue with some resource potential that is uninhibited by non-economic considerations, the conference developed a recommendation that the agency try to obtain ESF funds for balance of payments support that are not earmarked in advance for specific countries. Such funds could then be made available to countries whose governments are willing to adopt appropriate adjustment programs.

However, it may be a misleading simplification to pose foreign policy against economics. The real issue (and analytic challenge) may be to understand and weigh the

longer-run foreign policy implications of short-run economic deterioration, instability, or drift. A number of cases were described where moderate-sized aid, to countries with which the US has important mutual interests, was linked to their undertaking significant policy change, in some cases change carrying short-run domestic political risks. Where the US has persevered in such cases, there has been an implicit conviction, based on professional economic judgement, that the recipient's own long-run interests (and by the same token, mutual US long-run concerns) would be jeopardized by continued policy drift.

The point was made that failure to hold one country to agreed conditions (where, say, foreign policy concerns over rode non-adherence to AID loan covenants) had undermined AID's negotiating ability in other countries, especially in regions where governments are in the habit of keeping tabs on each other's dealings with the US. The Fund and the Bank can more easily maintain consistency.

The case histories show, however, that AID has certain strengths, compared with the IFIs, that lead to fruitful dialogue if the field mission has economic and negotiating competence, is allowed sufficient scope, and is supported by the embassy, with or without formal understandings or conditioning. As happened in Swaziland, Pakistan, Jamaica, and other countries, a resident AID economist can establish collegial relations with country economists and develop a professional basis (through a modeling exercise in the Swaziland case) for policy dialogue quite apart from a negotiation framework. Technical assistance is another basis that a number of the AID economists stressed, particularly apt because of the importance (recognized in IBRD's structural adjustment experience) of country competence in policy analysis for establishing the reality of a two-way dialogue and reducing resort to leverage against reluctance. Such technical assistance can take several forms, e.g., short-term consultancies by economists particularly experienced and recognized in specific subjects figuring in a structural adjustment planning exercise, or the financing of a series of policy studies and seminars (as in the Niger case). This conclusion was put into a recommendation that AID "stress institutionalization of policy analysis. . . support the formation of local policy analysis groups. . . support applied research of host country university economics faculties; provide support for advanced training for local economists and foreign service national economists."

The importance of country capability to master the technical issues under negotiation goes beyond immediate considerations of the negotiation relationship with a sovereign government, and touches on AID's function, as a development agency, to assist LDCs to attain self-reliance in technical capabilities. In this context it was pointed out that the decline of non-project, general training in the 1970s had resulted in a "generation gap" in many countries in terms of having a cadre with advanced training in economics. (In fact decline in such general training has also been occurring in the programs of other donors that had earlier been major funders of non-project, long-term training.) The quality of host country policy formulation may suffer as a result in many countries if efforts are not made soon to reverse this trend.

Not least among the factors said to have been important in determining AID's ability to conduct credible and influential policy dialogue was the professionalism of the mission. The discussants identified the specific determinants of professionalism: the extent of the mission director's training, understanding and interest in economic issues; how the mission allocated the time of its economist(s) between technical economic and non-economic work; the ability of the economists to spend time outside the office in developing relationships with local economists; and the organizational position of the economist in the mission, whether attached to the program office or the director's office, for example.

In the search for ways to increase the effectiveness of AID funds, in a period when policy dialogue is a prominent feature of donor-recipient relationship, it was not surprising that a maximizing view with respect to conditioning was expressed as one approach, viz, that the Africa Economic Policy Reform Program funds should be used to induce future actions, not to reward past performance. While this is a credible position, it has obvious dangers. As pointed out above, policy reform often requires sustained financial support for a few years after the policy changes have been made. Alternatively, good policy performance merits incremental support if changing external conditions threaten to force a government to lapse back into a control regime.

Except for the Indonesian case, missions not involved in economic policy dialogue were not heard from in this context. That is, the conference did not explicitly consider why some programs were completely oriented toward projects. The subject arose later however, by implication,

when the proceedings turned to the role of the economist in AID, including the question why economists in some missions were used only or mainly for project analysis.

Project Analysis

Although policy analysis is a subject that has faded and returned periodically in the history of US aid, economic analysis in project design and appraisal has a long track record in AID and has been a major area of its economic work. Economic analysis of projects also rests on a very substantial theoretical literature covering benefit-cost methodology, rate of return measures, shadow prices to value real resource costs, etc.

A surprising amount of skepticism was voiced over the role of economic analysis generally in project design. The commonly expressed view was that: a) such analysis seldom has an effect on project choice although the methodologies were developed for comparative analysis of investment alternatives; b) coming after projects had been chosen for other reasons, the analysis of the economic aspects was really a rationalizing exercise; c) the analysis of benefits and costs often was of dubious validity because the economics depended on parameters that were presented to the economist and that appeared to be without solid foundation or consistency from one project to another (see Ross for the example of lost work days in health project analysis); d) the analyses were frequently financial rather than economic, were weak on macro-micro relations, and had other methodological problems; e) once the project paper is approved, reexamination of the economics during project life is seldom done. In particular, evaluation as carried out in AID very seldom has an economic content.

The authors of these papers give several explanations of why the AID project process encourages a cursory role for economic analysis, e.g., pressure to "move things along," or the small size of many projects. It is also possible that these problems are more severe in least developed countries where data, host government project development capabilities and other factors make it relatively difficult to do economic analysis to professionally satisfactory standards. The conference could not attempt to evaluate these problems in such terms. The weakness of ex-post project analysis was stressed and is reflected in the recommendation that more economic content be included in project evaluation.

In the face of these difficulties, some of the participants had suggestions for useful, even if second-best, analysis. For example, least-cost analysis can help for comparison of alternative activities even if benefits cannot be quantified; analysis of distribution of benefits could result in improved project design. In general, to strengthen the contribution of economic analysis between the CDSS and project design stages, the conference recommended that Handbook 3 be revised to require economic analysis of projects at the pre-PID and PID stages of project development. Finally, the conference noted with satisfaction the forthcoming contract to revise the project economic analysis guidelines.

On Wednesday afternoon the conference took up the role of economic analysis in three subjects that do not lend themselves neatly to standard project treatment: private sector development, training, and science and technology. Promotion of development in the private sector (the term is normally taken in AID to emphasize the non-farming sector, including marketing, manufacturing, finance, services and other activities) can take many forms depending on the economic system of a country, its policy framework and market orientation, and the state of development of its entrepreneurial class. AID's special interest in small and medium-scale enterprises (SMEs) and in rural development was reflected in the presentations and discussion. Based on experience in Bangladesh, Van der Veen took up the importance of management and marketing capability as key constraints to SME development. He urged attention to sub-contracting as an arrangement that can overcome both these constraints. The market solution is built into sub-contracting relationships while the direct firm-to-firm interaction enables the smaller, less sophisticated firm to concentrate its scarce managerial talent on production and labor relations. His paper describes an imaginative project USAID/Dhaka is designing to promote sub-contracting in Bangladesh.

The development of an analytical framework for design of a private enterprise rural industrialization project in Thailand was described by Bob Muscat. The analysis began with micro surveys and interviews to learn about financial, technical, and other characteristics of rural enterprises, and to identify constraints in the environment and economic structure (market demand, price structures, skill supply, transport, etc.). An initial literature review was used to

identify problems and processes that might be pertinent based on analysis of other countries' experiences. A second set of determinants of enterprise status and constraints comprised the relevant institutions: banks, promotional agencies, some SME industrial extension services. Third was a product and sector analysis to identify activities with rural comparative advantages, forward and backward linkages, and the dynamics of Bangkok industrial agglomeration. Fourth was an examination of the macro-level framework--incentive structure (especially locational), determinants of provincial effective demand, pertinent government policies. From an examination at each of these levels and their connections, conclusions were drawn regarding policy and institutional, financial and technical activities that might make up a set of approaches most effective at this stage of rural industrial development. The conditions and dynamics of rural Thai enterprise were found to differ in some significant ways from what the economic literature suggested. For example, the sociology of family enterprise formation and growth was found to be a key to understanding enterprise behavior although the project development team did not actually include social science expertise trained in such matters. An exercise for the Caribbean Basin Initiative was also described, involving the drafting of a general private sector strategy. This exercise took the approach of identifying market failures to develop means for improving the workings of the market mechanism.

Privatization was also singled out as a specific objective of AID policy dialogue and technical assistance activities in a number of countries. In addition to the transfer of public enterprises to private ownership (which, it was noted several times during the conference had receded as an ideological issue and was being recognized increasingly as a matter of economic efficiency and fiscal viability), a number of examples were cited (by Lewis and others) of efficiency gains obtained through utilization of private-sector or market-oriented, rather than government-administered, operations. These included contracting out of public services, social marketing, and user fees.

The transfer to private dealers of public sector marketing of grain was an objective of policy dialogue in several countries. Missions in a number of countries have used negotiations over CIP programs, sector programs and projects as occasions to raise pertinent issues of government policy affecting private sector investment and operating conditions, frequently resulting in favorable policy changes.

Harold Lubell described some project options in an environment where the essential preconditions for private sector development (existence of an entrepreneurial class, and a sufficient level of technical capacity to support modern production methods) are in place, but where serious obstacles exist and are not yet amenable to policy change (e.g. ideological or cultural traditions inimical to a positive stance of the public sector toward private sector growth; entrenched parastatals; lack of confidence due to a history of expropriation or discrimination against entrepreneurial minorities). Under such circumstances, a country's informal sector may offer opportunities less hampered by these obstacles, e.g., funding through specially oriented intermediaries, supporting PVOs (like the PISCES projects) and technical assistance to medium-scale enterprises.

The reader should consider these observations on field experience against the background of Clarke's paper which discusses the forthcoming AID policy paper on private enterprise development, and which reflects the rising importance in AID of the public-private policy issues and of private sector project work. The policy paper's call for AID attention to policy, regulatory structure, research, and financial and other services, in connection with project and non-project assistance, implies an important role for economic analysis at various stages of field program development, from CDSS to project.

As described by Clarke, the private sector policy paper would have several elements of guidance that might not form an entirely consistent set of objectives for a mission and that would require some artful economic analysis in specific situations when a program strategy is being devised. One might easily imagine circumstances where provision of concessional aid to a country with a serious structural external imbalance, could not readily be channeled to the private sector while simultaneously meeting the predominant objective of serving the relatively poor and also maintain neutrality among enterprises by not giving one firm competitive advantage over another.

The main body of Clarke's paper however provides the only analysis prepared for the conference in the area of privatization, although the subject came up several times as participants discussed country experience where privatization was an element of a structural adjustment program. Clarke differentiates between divestiture, and the evolution of a parastatal to a private-like entity, induced

and required to behave as if it were under private ownership and management. The distinction is important because recognition of the economic efficiency and market behavior objectives of the critics, as against the ideological distaste for public or for private ownership, has helped to lower the importance of political overtones in policy dialogue over state enterprises. One might quarrel over the historical importance for parastatal development of economists (Abba Lerner for example) who developed the theory and methodology for efficient publicly owned enterprise. In any case the failure of parastatals to operate as Lerner recommended has brought them into widespread disrepute, as Clarke points out.

The upshot is a need for practical steps either to develop incentive systems and new market-oriented decision rules for parastatals, or to divest or shut them down. Good analysis and technical assistance can be very helpful for either route. Clarke gives several interesting examples of parastatal reform programs that illustrate what can be done, along with a useful bibliography of recent theoretical and descriptive materials.

On the economics of training projects, both methodology for analysis and some innovative project content were discussed. Mike Gomez from IDB described some of the Bank's training activities in these respects, including work on introducing cost recovery, training by small enterprises, and a national training institute with mixed public-private funding and fees. While some components of training project analysis were identified (comparison of cost-effectiveness of training techniques, determining priorities among alternative subjects for training, financing systems), the limitations on economic analysis were recognized, including among other things, the common difficulty of collecting the kinds of information such analysis requires.

The brief session devoted to the role of economic analysis in the area of technology development and transfer was somewhat diffuse and no prepared papers were presented. A number of the elements for tackling this cross-cutting subject were discussed: research choices and strategies; institution-building strategies; criteria for determining size of R&D resource allocation; efficiency issues in the technology diffusion systems traditionally supported by AID (e.g., agriculture extension); policy environment issues (taxes, patents and license regulation, salary levels in science occupations); indirect impact issues (employment); importance of commercial linkages; the "culture" and incentive systems of enterprises and their interest in and

efficiency regarding technological change. In addition, some activities AID might promote were suggested: assistance on technology problem-solving processes rather than simply transferring specific techniques; relevant policy dialogue; and contract farming, franchising and other transfer-process arrangements.

The technology discussion in particular invites a few post-conference observations. Technology transfer has been a central activity of development assistance since Point IV days. The emergence of science and technology (S&T) as a subject or "sector" in itself goes beyond the issues of access to intellectual property that were the first concerns raised by LDCs as comprising a North-South set of related S&T problems. The network of scientific research institutions, educational facilities, and technology diffusion mechanisms common in all industrial countries is recognized as the intellectual base of modern economies, more important as a source of wealth generation than natural resource endowments or even the volume of capital formation taken in isolation. For countries approaching or already qualifying for "newly industrializing country" status, the extent and efficiency of the scientific and technological infrastructure becomes a major development subject, and one for which technical assistance from the scientifically advanced countries is at least as important as it has been at earlier stages of development (whether concessionally or commercially financed).

Despite its fundamental importance, there have been few attempts thus far to assess the S&T state of particular LDCs in a systematic and comprehensive way, and even fewer attempts to develop assistance projects designed in a rational manner to meet the S&T development needs of a country at a specific stage and in relation to the evolving economic structure of the country and the intellectual needs for supporting that evolution. The literature relevant to development assistance activities in this field, including methodologies for assessment, infrastructure mapping, and analysis of the dynamics of institutional and enterprise behavior and relationships respecting generation, application and adaptation of technologies, is still in an early stage of development compared with the literature on industry case studies, international legal aspects, multinational restrictive practices, and guidelines for development of individual institutions. Many AID programs are in countries where such considerations will not be pertinent for many years. But many other programs, including some of the agency's most important, are in

countries advancing rapidly toward need for, and ability to absorb and apply the more advanced technologies in many fields. In the limited work that has been done along the lines indicated above, economic analysis has played an important role, albeit in a multi-disciplinary way only partially reliant on traditional economics tools. Serious thought needs to be given to the agency's own research and methodological development requirements for moving ahead in this area.

Quantitative Tools, Microcomputers and Economic Modelling for Program Analysis and Policy Dialogue Purposes.

The Conference included a number of sessions on the use of quantitative techniques, economic modelling and micro computers for both macroeconomic and project level analysis. Applications from a wide range of areas were presented, including natural resource and environment project analysis, risk analysis and agricultural project analysis. Spreadsheet programs, statistical analysis packages, and other software were described and demonstrated in evening workshop sessions. Examples of spreadsheet program applications included Rick Harber's presentation on his use of LOTUS 123 and its "macro" programming capability to build a foreign exchange requirements forecasting model for the African Bureau, and a demonstration by Bonnie Blarcom on her use of LOTUS to produce crop forecasts and analyze agricultural projects. Alex Meeraus of the World Bank described--GAMS (General Algebraic Modelling System), a powerful programming language developed at the World Bank for economic modeling applications ranging from linear programming sector models to computable general equilibrium models, which is now being adapted for use on micro computers. Szabolc Szerkeris, a consultant, described a micro computer based program to do cost benefit analysis explicitly incorporating systematic sensitivity analysis of risk and uncertainty. John Dixon, of the East-West Environmental and Policy Institute discussed the Institute's work in developing economic analysis techniques for natural resource and environmental projects. Richard Collins discussed economic data available through the AID computer system and how it can be accessed, while Cathy Gleason and Jim Feaster of AID Technical Resources Center in another session discussed statistical packages and other microcomputer software of interest to economists. Conference attendees had the opportunity to gain actual "hands on" experience on micro computers with a number of micro packages.

A plenary session involving extensive audience participation was conducted by Cathy Gleason from the Technical Resource Center, on the subject of micro computer hardware and software availability and procurement. Attention focused on needs of economists in the field in these areas.

A plenary session was devoted to macro modelling and its uses for AID programming and policy dialogue purposes. A wide variety of models were presented and discussed by the four panelists. For more details the reader is referred to the papers in this section of these proceedings. Yoon Lee's paper and presentation, drawing on his applied research work and World Bank experience, focuses on the uses of effective rates of protection and domestic resource cost modelling for analyzing trade and resource allocation issues. Two papers, one by Neal Cohen, focusing on budgetary and fiscal policy issues in Swaziland, and another, by Elliott, Kwack and Tavlas, analyzing fiscal and exchange rate policy choices for a small open developing country (Kenya) in a multisectoral context, presented examples of country-specific macroeconomic models developed for forecasting and policy analysis purposes. In a subsequent evening workshop session, Cohen gave a "hands on" demonstration of the microcomputer implementation of his model. Michael Crosswell's paper introduces social accounting matrices (SAMs) and computable general equilibrium models (CGEs); examines the linkages between SAMs and CGEs; and discusses some of the limitations of GEMs as a tool for policy dialogue in AID.

ON PROFESSIONALISM IN THE STUDY AND FORMULATION OF ECONOMIC POLICIES IN DEVELOPING COUNTRIES

by Arnold C. Harberger

Introduction

On being asked to address this group, I felt that the most appropriate focus would be on the ways in which the science or profession of economics interacts (or perhaps better, can hopefully be brought to interact) with the diagnosis of events and the formulation of economic policy in developing countries. In so choosing, I take it for granted that you are all, in one sense or another, veterans of this process. You know the many obstacles along the way. You have learned how close to infinite may be the amount of patience demanded, as one seeks to bring common sense and rationality into a policymaking process that has failed or is failing. You have all, I am sure, had to face disappointment and frustration--probably many times over--after putting all your energy and spirit into the effort to bring about one or another improvement in or rationalization of economic policy in a country where you were stationed or with which you were otherwise concerned.

No one needs to tell you that economic policy cannot be mass produced--in Washington or Chicago or Cambridge--and then retailed in prefabricated modules to the developing countries of the world. The countries of the world are all different--and even when they are quite similar their peoples viscerally resist being likened by an outsider to other peoples; in this case they go out of their way to emphasize their dissimilarities.

A sort of corollary of the above is the fact that most natives or citizens of most places (be they cities, states, or countries) tend to have a natural resentment against what I call the "instant expert"--he who, on first setting foot on local soil, already has in his pocket the solution to a problem (or two or three) that has vexed the place for years.

Dr. Harberger is affiliated with the University of Chicago and the University of California in Los Angeles. He was the keynote speaker for the conference.

This aversion to the "instant expert" is perhaps in large part a reflection of the importance of non-economic values--of the traditions, the ways of doing things, the power structure, the rivalries among individuals and groups, etc. The new arrival generally knows little about these things, and his pre-packaged solutions do not in general take them into account.

Most of you have, I am sure, witnessed reflections of this resentment against instant experts. But many of you, too, have probably seen cases where the differences between the instant expert and the seasoned one was simply in the way a plan or proposal was couched and presented--the one presenting it in a fashion as if it had been lifted verbatim from a textbook of economics, the other entwining the economic lessons with all sorts of references--references that reveal that he truly (or as truly as an outsider can) understands the realities, the idiosyncrasies, the peculiarities, the "special considerations" relevant for this particular place. This may be just sugar-coating the pill, but many times the pill just won't be taken without the coating.

But in addition to the adaptation of ideas to the local culture, as it were, there are also cases of genuine conflict between economic and other objectives. On the whole, it is not the place of the economist to insist that economic objectives should take precedence over other ends--indeed, economics has often been called "the science of choice" among conflicting or competing ends. Rather, it is the economists' task to, as it were, represent the economic point of view in the forum of public discussion and debate. Medical professionals, like all of us, will and should have opinions on the whole range of policy matters, but somehow the medical profession, viewed as a group, is the place where the technical problems of public health policy have to be joined and debated. The task of bringing these matters to the attention of policymakers and the public simply cannot be left to others. Similarly, while economists recognize that values other than economic ones are important, and that a society is not ipso facto irrational if it gives up some economic progress in favor of other ends, they should also be aware that it is basically only they (the economists) who can properly represent the economic point of view. It is their role to state that point of view, and to make policymakers aware of the tradeoffs between economic and other goals. Much of the time, indeed it turns out that there is not much of a tradeoff--i.e., many noneconomic goals can be achieved (with

well designed legislation and policy) at a small or even minimal sacrifice of economic objectives.

From between the lines of the foregoing paragraphs, readers should be able to discern the outlines of the professional's approach to the relationship between economic policy and economic growth. First of all there is an incredible number of ways in which policy can influence the growth rate, either for good or ill. The task is to try to see to it that as many as possible of these avenues are exploited for the good. In the second place, it is clear that governments operate under political and social pressures from many different sources; it would accordingly be foolhardy to expect those governments to march solely to the economists' drumbeat in their formulation of policy. Third, one must recognize that to the extent that governments follow the best of other drummers, they will likely be sacrificing some amount of economic progress. Finally, the art of successful economic policy consists in a government's having as high as possible a batting average in the countless decisions it has to make that impinge on the national economy, in its finding ways, when it feels constrained to yield to other forces and pressures, to do so in a fashion that involves as little sacrifice or compromise as possible of sound economic objectives, and in its being zealous in avoiding critical errors of macroeconomic policy.

Some Lessons on Economic Policy

This is not the place for a dissertation on the "science" of economic policy, yet readers deserve to know at least something about the way policy economists go at their business, and about what they consider to be important goals and desiderata in economic policy. The following paragraphs represent an effort to convey at least the flavor of how policy professionals tend to look at these matters.

First, the professionals are quick to recognize that one should avoid false technicism in economic policy making. Too often, and in too many countries, the task of economic planning has been conceived of as that of making projections (predictions) of the future progress of the economy. Sometimes these predictions have been elaborated in incredible detail, to the point of projecting the output of individual industries five or ten years into the future. Such exercises simply have not paid off; they have been a waste of good talent and money; they have distracted able people from the more important task of attacking the real policy problems of the economy; and, to make things worse, the predictions have generally been wide of the mark, and

have often been corrupted by being commingled with political promises and propaganda.

Second, professional economists are profoundly convinced that countries must keep their budgetary processes under adequate control. This does not mean that budgets must be balanced, but it does mean that there are severe limits to the size of budgetary deficits that can be incurred with relative impunity. Somewhere along the line, the budgetary authorities have to learn to say no to spending requests, and standing behind them, governments have to learn to resist the pressures to spend more. The time for governments and budgetary authorities to take their stand is clearly before budgetary discipline has broken down. Some bending and yielding there will (and probably must) always be, but once the authorities have caved in too many times, it is as if a dam had broken, and they become overwhelmed by the flood of requests pouring in from newly-hopeful solicitants.

Third, the inflationary forces that virtually any economy is capable of unleashing must be kept under reasonable control. Most of the major inflations that we have witnessed in the postwar period have had their roots in excessive fiscal deficits (see the previous point) which the governments could only finance by resorting to the printing press--this is the case in Argentina, Chile, Indonesia in the 1960s, and in the recent eruptions of inflationary forces by printing money in order to grant credit to the private sector.¹

Fourth, it is a matter of genuine consensus among seasoned professionals of economic policy that countries should take advantage of the opportunities that international trade affords them. It may be that most policy professionals are, deep down, free traders at heart. But this is not the way they speak in policy forums--on such a politically incandescent topic as protectionism, discretion must be the watchword if a professional's credibility with different groups is to be maintained. Thus, rather than indulge in panegyrics lauding the virtues of free trade, modern policy professionals tend to emphasize the strategic choice between having a relatively closed economy on the one hand and having a relatively open one on the other. The relatively closed economy, they take pains to point out, is characterized by a low level of imports relative to GDP (a consequence of import restriction) and a relatively low level of exports (a consequence of the way the effects of import protectionism work through the economy--generally causing internal costs to rise relative

to the prices that exporters receive). In a real sense, the act of protecting imports operates to disprotect exports, and introduces potentially very serious distortions into the pattern of trade and the allocation of resources within the economy. The task at this stage, as seen by policy professionals, is to keep the degree of these distortions within moderate limits so as not to reduce the volume of trade very seriously below its potential.

Fifth, policy professionals are also wont to improve the structure of trade restrictions, for some types and patterns of restrictions can be far worse than others. Economists' understanding of restrictive processes took a giant step forward in the 1960s with the development of the concept of "effective protection." It was found, among other things, that the very same tariff on a final product can imply incredibly different amounts of effective protection, depending on how important are imported² inputs into the productive process and how they are taxed. The only sure way to guarantee against catastrophic variations in rates of effective protection, even with moderate looking rates of nominal protection on final products, is to make the rate of nominal protection uniform across all final products. This obviously means including raw materials and capital goods in the list of commodities subject to the uniform rate of protection. Even goods that are not produced in the country, and perhaps can never be, should still be subject to the uniform rate so as to keep "honest" the degree of effective protection granted to products in which they are inputs.³ For only when all nominal rates of protection are equal do the effective rates on all products turn out to be equal to this same nominal rate. Only in this way are capricious and distorting variations in effective rates of protection automatically voided, that is, only by setting a given uniform rate of tariff can policy makers assure themselves of exactly what level of effective protection they are getting. For this reason, one of the important reforms advocated by professionals in the economic policy field has been the modification of tariff schedules in the direction of greater equalization

Sixth, if import restrictions get to be excessive, and their direct reduction proves intractable for political reasons, the policy professionals would advocate an indirect attack on the problem so as to provide additional incentives to export, helping to compensate the anti-export bias that import restrictions automatically carry with them. The most natural instrument for accomplishing this aim is the rebating, at the border, of the indirect taxes that have

been incurred in the process of producing the export good. This sort of rebating is explicitly approved by the General Agreement on Tariffs and Trade (GATT), and has been implemented in whole or in part, by a large number of countries. Above and beyond the devolution of indirect taxes, there are other devices (e.g., the rebating of all or part of direct taxes incurred in the production of an export good, more drastic still, the direct subsidization of exports) which, though not approved by GATT, have nevertheless been used by some countries, and which are, up to a point, supported by technical economic reasoning. Such devices are "good" so long as they operate to offset or neutralize pre-existing distortions (in this case import restrictions). When this neutralizing function has already been fully implemented, further use of the same policy devices now ceases to be a corrective, and instead becomes a new source of distortion in the economic system.

Seventh, policy professionals are in widespread agreement that the tax system, in addition to producing sufficient revenue to avoid excessive deficits, should be simple, easy to administer, and (to the degree that it is possible) neutral (i.e., non-distorting) with respect to the allocation of resources in the economy. One tax that epitomizes these three attributes to the value added tax. First introduced in France in the early 1950s, this tax has come to be the most important source of revenue in close to half the noncommunist world. Its neutrality--perhaps its most distinctive attribute--stems from the fact that as goods pass through successive stages of the productive chain, they are taxed only on the value added at each successive stage. Thus by the time they take shape as final products, each element or component of the final product has been taxed just once. This tax is a great improvement over the system it replaced in most of the countries where it was adopted. That was a sales tax system of the so-called "cascade" type, which taxed a good on its full value each time a sale took place as it moved through the productive chain. This obviously ended up taxing the value added of the early stages several different times, and also generated a strong artificial incentive toward vertical integration of productive processes.

Eighth, exaggerated rates should be avoided in income taxation. Little economic justification can be found for rates in excess of fifty percent on any type of income, as the excess component of the rate generally has very strong distorting and disincentive effects, while yielding little revenue. In general, policy professionals favor the careful and prudent design of tax structures, with due attention to

details such as (a) permitting business firms a proper recovery of capital (for tax purposes) over the economic life of an asset, and (b) preventing the calculation of income for tax purposes, and of the consequent tax liability, from being grossly distorted by inflation.

Ninth, one should also studiously avoid the excessive use of tax incentives to achieve particular objectives. The use of such incentives has been particularly common in a goodly number of Third World countries. The Brazilian law favoring investment in the Northeast (and in Amazonia) is a good example. Under this law, a firm in another region, which owed the government 1000 in corporation income tax, could take 500 of this and invest it in an approved project in the Northeast, and end up paying only 500 in tax. In truth the firm would be investing money that would otherwise belong to the government, but the firm would have claim to the income produced. Note that the firm would be better off even if it ended up extracting only 200 or 300 from its investment of 500 (i.e., the firm earns even if it makes very bad investments).

Another case was an investment tax credit rate of 30 percent, which was in effect in Bolivia in the mid-1970s. Under this law, a firm could invest 1000, yet have only 700 of "its" money involved. The remaining 300 would be money that would otherwise have been paid in taxes to the government. Such a firm would probably be quite content if the investment produced a relatively quick return of 900 (viewed in the light of "its" capital-at-risk of 700), yet from an economic point of view the investment would be a disaster (900 of return on an economic investment of 1000). All investment tax credit schemes share this basic flaw; in the Bolivian case it is just easier to see because of the very high thirty per cent at which the tax credit was granted.

Tenth, price and wage controls should be used sparingly, if at all. They are rarely (if ever) justified on strictly economic grounds, so at the very least they represent a situation of non-economic objectives impinging on strictly economic goals, tending to frustrate the achievement of the latter. Price and wage controls tend in particular to vitiate the critical signalling role that prices are supposed to play on the economic scene. High prices should reflect scarcity and attract resources to the activity on question; low prices should reflect abundance and help keep unwanted resources away. Most price control situations reflect efforts to keep prices low in the face of scarcity, or, what often amounts to much the same thing, to perpetuate prices which used to prevail, in the face of

drastically changed circumstances. The typical consequences of price controls in such situations are (a) production, responding to the signal of a low controlled price, fails to increase and may even decline in the face of scarcity, and (b) black markets emerge, frustrating for at least some buyers the efforts of government to keep prices low. Little good has ever come from government ventures into the swamp of price and wage controls.

Eleventh, quotas, licenses and similar quantitative restrictions on output, imports, exports, and other economic variables, often found in tandem with efforts at price control of various types should be avoided. Only rarely can a cogent economic justification be found for such practices; for this reason policy professionals view them with great suspicion. In general, such restrictions almost automatically indicate that resort is being had to some criterion other than price for rationing the limited supply among contending demanders. This gives easy scope for favoritism, which in practice can (and often does) readily generate into corruption. These evils are then added to the fact that such quantitative controls almost invariably compromise the goal of economic efficiency.

Twelfth, and finally, policy professionals tend to take a rather technical view of the problems associated with public sector enterprises. The professionals have typically seen too much of the world to take a dogmatically ideological position in connection with public enterprise. Some public enterprises, they know, have succeeded, while others have compiled records that no one will ever envy. The differences between the successes and the failures, it seems, can best be summarized by saying that the successful public enterprises have on the whole been permitted by their governments to behave like enterprises. If the government is intent on using public sector enterprises as vehicles in the pursuit of all sorts of non-economic goals, then almost inevitably their success as economic entities is put in peril. The ways are countless in which governments have encroached on the economic functioning of their enterprises. They have artificially kept down the prices of the goods and services that public enterprises sell--this is dramatically true for electricity, gas and telephone companies as well as other public utilities. They have required the enterprises to pay above-market prices for inputs--most particularly for manual (blue-collar) workers, but also often for materials, via rules that preclude the enterprises from seeking least-cost sources on the international market. They have also set maximum salaries (usually related to those of high government officials) that

were far below those prevailing in the private marketplace for major business executives. If under those circumstances public enterprises succeed in attracting management comparable to those of similar private enterprises, it is only because some particularly dedicated people may be willing to make major financial sacrifices at the personal level. In addition, many public sector enterprises are routinely precluded from taking the tough decisions that often make the difference between viability and failure--to shut down a product line, to close a plant, to lay off workers when demand falls.

The policy professionals know that all of the above possibilities represent threats to the economic viability and success of public sector enterprises. They realize that in these senses public sector enterprises are at an inherent disadvantage (in the search for economic efficiency) vis-a-vis private sector enterprises. But at the same time they realize that there are a number of public sector enterprises--in a goodly number of different countries--that have somehow managed to surmount these obstacles and turn in good, at times even outstanding economic performances. These successes have been achieved only through some sort of (at least tacit) understanding between the enterprise and the government, to the effect that the enterprise will not be forced or pressed to behave in an antieconomic fashion. These are the cases which the policy professionals are prone to hold up as models for the rest.

The above vignettes should impart to readers at least some insights into the way of thinking of most policy professionals. It should be clear from these examples that policy professionals believe that they can recognize instances where economic policy is "good" as well as cases where it is irremediably bad. It should be clear, too, that some cases would be difficult to classify, but also that on the whole such cases are complex mixtures of good and bad elements, with the policy professional remaining quite confident of his capacity to tell one from the other. Finally, it should be clear that good policy, as judged by policy professionals, does not carry with it any particularly heavy ideological or political overtones. Certainly good policy would appear to be feasible in the hands of European Social Democrats or Christian Democrats or Socialists, also in the hands of British Conservatives or Laborites, or of American Democrats or Republicans, or indeed of the great bulk of political groupings that are likely to rise to governmental power (in the non-communist parts of the world) in the foreseeable future.

Footnotes

¹ Although during the last few years, inflation in Uruguay seems to be of fiscal origin, that country's inflation over more than two decades was principally due to the excessive extension of credit to the private sector. The same can be said of Brazil's inflation between the mid 1960s and the mid 1970s. In both cases the excessive credit expansion was mainly centered in a state bank (the Banco de la Republica in Uruguay and the Banco do Brasil in Brazil) which was not under the effective regulatory control of the Central Bank and which acted with an almost imperious autonomy.

² If a final product costing 100 in world markets is granted a tariff of twenty per cent, and if the local substitute uses sixty of imported inputs, which enter duty free, the production of the local substitute saves only 40 ($=100-60$) of foreign exchange. But since the internal price can now rise to 120 ($=100+20\%$), the local firm will make money so long as its costs do not exceed 60 ($=100-60$). Its costs can be as high as sixty in order to save forty of foreign exchange; its "effective protection" is therefore 50% [$= (60/40) - 1$]. Let the product in question be a woolen sweater, and the imported input be woolen yarn. Suppose, too, that some firms in the country make cashmere sweaters, which sell for 200 in the marketplace and use 160 of imported cashmere yarn, which also enters free of duty. Now the degree of effective protection is much higher. A twenty per cent tariff on a world price of 200 means that the internal price can rise as high as 240. The imported input (cashmere yarn) costs 160. Hence domestic costs of up to eighty can be incurred (behind the twenty per cent tariff barrier) with the operation still yielding a profit. Since only 40 ($=200-160$) of foreign exchange is saved, and since up to 80 of domestic costs can be incurred in order to do so, the effective protection in this case is 100% [$= (80/40) - 1$].

³ If the yarn used to make woolen sweaters (in the example of the preceding footnote) were subject to a twenty per cent duty, the cost of imported inputs would have been 72 ($=60$ plus 20%). The margin for profitable use of domestic resources would have been 48 ($=120-72$), which, taken together with a foreign exchange saving of 40 ($=100-60$), implies effective protection of 20% [$= (48/40) - 1$]. If the cashmere yarn had been subject to twenty per cent duty, its cost per cashmere sweater produced would have been 192 ($=160$ plus 20%). The final product, with a twenty per cent duty, could sell for up to 240 ($=200$ plus 20 percent). Domestic costs of up to 48 ($=240-192$) can therefore be incurred in

order to save forty of foreign exchange. Effective protection is thus once again 20% [=48/40) - 1]. The general formula for the rate t_{ej} of effective protection of activity j is

$$t_{ej} = \frac{t_{nj} - \sum_i \alpha_{ij} t_{ni}}{1 - \sum_i \alpha_{ij}}$$

where t_{ni} is the nominal rate of protection accorded to imported input i and α_{ij} is equal to the fraction of j 's total costs (measured at world prices) that are accounted for by imported input i . It is easy to see that when $t_{nj} = t_{ni} = t^*$, i.e., when a uniform tariff of t^* prevails,

$$t_{ej} = \frac{t^* - \sum_i \alpha_{ij} t^*}{1 - \sum_i \alpha_{ij}} = \frac{t^*(1 - \sum_i \alpha_{ij})}{(1 - \sum_i \alpha_{ij})} = t^*.$$

That is, all effective rates of protection are equal to t^* when that is the nominal rate applying to all imports.

Findings and Recommendations of the
1984 Conference of AID Economists

1. To promote the adoption of effective policy measures to achieve economic adjustment objectives, it is recommended that consideration be given to obtaining ESF funds for balance of payments support that are not earmarked for specific countries. This would enable the Agency to make such funds available to high priority countries whose governments are willing to adopt appropriate adjustment programs.

2. The adjustment measures that AID should request as conditions for its balance of payments assistance should be linked to those considered crucial to the success of the adjustment program. The relative merits of the "gradual adjustment" versus the comprehensive "big bang" approach should be investigated further. It is clear, however, that corrective policy measures should be adopted as early as possible, as the economic costs of delay are extremely high.

3. To promote policy dialogue and analysis AID should stress the institutionalization of policy analysis capacity in host countries. AID should:

- a. support the formation of local policy analysis groups made up of host country economists, the AID economist, and other appropriate economists or analysts;
- b. provide active support for institution building and applied research in host country university economics faculties and/or research institutes; and
- c. provide support for advanced training for local economists and foreign service national economists.

4. The targets of multiyear programs should be reviewed annually for possible adjustment; specific economic policy performance targets should not be established more than one year in advance.

5. Efforts to develop country economic models can be useful in providing a valuable analytical tool and as a means to facilitate the exchange of professional views among AID and host country economists.

6. It is recommended that more systematic economic analysis be incorporated at the pre-PID and PID state to

assist in the selection and early design phase of project development. It is further recommended that the financial analysis and economic analysis sections of A.I.D. Handbook 3 be revised. (Note: In April 1985, A.I.D. signed a contract with the Georgia Institute of Technology to prepare an economic analysis project manual. The Agency has also decided that the financial analysis project guidelines [also in A.I.D. Handbook 3] requires complete revision.)

7. It is recommended that more economic content, both qualitative and quantitative, be included in evaluation; that the same methods used to analyze a project ex ante be used to examine the project ex post; and that projects be designed to include collection of baseline data and data at the end of the project that facilitate this analysis.

8. It is recommended that PPC/EA serve as coordinator, in close collaboration with the regional economics offices and economics offices of other bureaus, to promote and support the continued improvement of AID's economic analytic capabilities.

9. It is recommended that consideration be given to the establishment in Missions of planning offices concerned with policy, research, program planning, strategy and evaluation. The planning office should include the program economist, the agricultural economist, and other social scientists. In cases where no planning office is established, it is usually preferable for the program economist to report directly to the Mission Director.

SECTION TWO:

STABILIZATION, STRUCTURAL ADJUSTMENT,
AND LONG-TERM DEVELOPMENT

Hans Gerhard

Stuart Callison

Balance of Payments Stabilization

by Hans Gerhard
International Monetary Fund

Introduction

The Fund was founded to help countries attain quite lofty socioeconomic goals--but the immediate objective is balance of payments stabilization. There are some systemic features of world monetary arrangements which were meant to make special balance of payments stabilization efforts unnecessary for most countries most of the time--if only they adhered to those arrangements as agreed under the Bretton Woods charter and as monitored by the Fund. But for those occasions when friction or slippages made for temporary deviations from balance of payments equilibrium for individual countries, the Fund was to stand ready with financial resources of its own to smooth the path of necessary adjustments, giving a country a little extra room to maneuver, allowing for more gradual and more orderly adjustment than otherwise might be possible. But even in that comparatively idyllic scenario there was cause for caution: none of the members expecting to be more often on the creditor rather than on the debtor side in this financial cooperative was inclined to take excessive risks. So, from early on there was a consensus in the Fund that lending should be subject to adequate safeguards to protect the revolving character of the Fund's resources--and thus, to retain the line of demarcation between balance of payments stabilization and longer-term development aid.

To make such safeguards effective, the Fund had to develop lending policies which under the label "conditionality" never fail to stir lively debate. I am not proposing to feed this debate with additional slogans nor kill it with too many facts. Instead, I propose to talk briefly about some aspects of the Fund's work that should be relevant to your own work.

First, I propose to talk about method. Then a bit about content and, finally, about results.

Elements of "the Fund Approach"

To help judge whether a proposed use of Fund credit is likely to be temporary and can be repaid on time, we need to

make predictions about balance of payments developments. Obviously, we cannot claim to know the future any more than anybody else. Worse: we cannot even claim to know more economics than everybody else. But since that is our central task, it was clear early on, that we needed to shape such knowledge as we and others could glean from study and from experience into analytical tools specially suited to that task. That has been done although the task is never quite over as further use of these tools suggests modifications, improvements and perhaps additional, specialized instruments. But there has been enough common ground for long enough now that there is a recognized label (viz: monetary approach to the balance of payments [MAP]). There has also been enough variation of this theme to have produced a lot of misunderstandings. For both these reasons, it may be worthwhile to briefly talk about what might be called the "Fund approach" as reflected in the adjustment program supported with Fund credit.

We, ourselves, regard as the core of our work what we call financial programming. We mean by it an attempt to quantify variables that together will produce outcomes in line with targets in respect to internal and external balance. Thus, if the balance of payments or the rate of inflation is chosen as a target, magnitudes for the other variables will be chosen so as to be consistent with the target, with each other, and with one's knowledge of the economy and of exogenous factors. The implications of particular sets of internally consistent figures may be politically unacceptable to a country. Where that is the case, the targets will need to be modified and the exercise restarted because to change one element always means that others have to be changed too. Indeed, this is perhaps the most useful aspect of this iterative method: the need to quantify the likely effects of alternative policy measures focuses discussions on the tightness of links between the various sectors of an economy and between the various areas of economic and financial policies.

One may also start the programming exercise from the supply side of the economy: a certain level of production will require a certain level of imports, and of finance to sustain it. These levels may be ascertained from an analysis of the economy's behavior. Then the matching level of demand is determined, adding up government and private demand. The level of government demand depends on fiscal policy and that of household demand on the financial resources available to households, on expectations with regard to the rate of inflation, interest rates and on other behavioral factors. The levels of supply and demand chosen

should be consistent with targets or possibilities for the balance of payments and the rate of inflation. They should also be mutually consistent in that, for example, the flow of income to households will be a function of the level of production.

To check the estimates and projections of this variety of real and financial variables for consistency, the Fund staff generally uses an accounting framework derived from the consolidated balance sheet of the country's banking system ("monetary survey"). This framework gives, of course, no more than should be expected from accounting statements which show that, ex post, a change in the stock of money must always, by definition, equal the change in net domestic assets (credit from the banking system net of government deposits) plus the change in net foreign assets (NFA) of the banking system.

For policy purposes, it is, of course, not enough to look at accounting equations. These equations hold true at all times, regardless of policy because they describe ex post relationships. What is wanted for policy selection is an ex ante equality, a relationship that then acquires meaning as an equilibrium condition. In that sense, it may be read as saying: if a certain change in NFA is desired, it can be brought about only if the autonomous or policy induced change in net domestic credit and the demand for liquid assets by the public (the demand for money) together are consistent with this change. If net bank credit changes exceed those that are consistent with this equilibrium condition, the excess will be reflected in a loss of foreign exchange at the banks--either because the initial excess of domestic liquidity finds its way into additional imports or into financial claims on foreign banks or firms.

The use of this "monetary approach" for purposes of policy selection rests on some weighty theoretical postulates: a predictable demand function for money, and a stable process of money supply generation. There are severe simplifications involved in both these postulates, and in real life a number of ad hoc adjustments have to be made, but with various modifications it has been found that the basic approach stands up quite well in empirical testing. In other words, the model explains the behavior of the balance of payment (and income) in a satisfactory manner for quite a wide variety of countries.

The importance attached by the Fund to monetary aggregates, and especially to the relationship between domestic money and credit developments and the balance of

payments, is widely known--not to say notorious. A cursory look at any batch of stand-by arrangements confirms that, indeed, the Fund ascribes pride of place to this relationship and centers most of its programs on quantitative limitations on the growth of domestic credit. No other quantitative feature occurs with greater regularity among the performance criteria adopted for monitoring stand-by and extend arrangements than a ceiling on the overall credit. In fact, practically all upper tranche stand-by and extended arrangements approved in recent years have contained overall credit ceilings as one of the performance criteria. That has been true for programs mainly conceived as instruments of improved demand management, as well as those primarily oriented toward supply policies. In both types of programs demand management is usually seen as an important area of potential improvement, and the management of aggregate demand is seen as closely linked to credit developments and credit policies.

The Policy Content of Fund-Supported Programs

Both with regard to the methods of programming and the policy content of adjustment programs the Fund is quite flexible. That is to say, there is no standardized package that would be applied across the board to all cases. Each case is approached in its own terms within the overall constraint that policies must be adequate for the size of adjustment necessary--and they must be compatible with the code of conduct to which each Fund member subscribes. Thus, trade and payments restrictions in their manifold forms are never regarded as acceptable means of balance of payments adjustment, nor are expectations about the future development of key economic or financial variables acceptable if these expectations are not based on reasonable projections and explicit policy undertakings by a country's authorities.

Obviously there is wide scope for differing interpretations of facts and of the likely impact of policy measures. We are not protected from the normal risks of working economists! And we certainly contribute our share of the mistakes of the profession. However, in judging success or failure of Fund-supported adjustment efforts among our members, one should remember that we are often involved in cases where there has been a history of almost intractable problems, both of the exogenous and of the home-made variety, e.g., Zaire.

Having said that Fund-supported programs do not rely on

standardized packages of policies, I should perhaps acknowledge that there is nevertheless a strong family resemblance in those arrangements. And that should not surprise anyone because despite all their individuality and special situations, countries applying for balance of payments assistance have a lot in common: mostly that their balance of payments problems are fairly long standing, are not amenable to easy technical solutions, and often involve structural as well as functional maladjustments.

One very common misunderstanding should be cleared up right away: virtually all substantial Fund lending occurs under stand-by arrangements. These provide for a phased drawdown of the amounts agreed in advance subject to concurrently phased performance tests. These tests are based on criteria taken mainly from quantifiable macroeconomic variables, particularly certain monetary aggregates. These are primarily chosen for their suitability as monitoring devices; as variables sufficiently general to permit more than one way of meeting the test, sufficiently significant to react sensitively to the economic and financial process under way in a country, and quickly enough available to avoid excessive lags in the process of loan disbursement. These characteristics determine the choice of performance criteria, and it can therefore not be surprising if in this respect Fund arrangements are highly standardized. But this does not say much about the policy content of programs supported by these arrangements. And indeed, any close look at these programs will reveal great diversity, running the full gamut of the economist's tool box.

Usually, adjustment programs that we support are, at least initially, focused on controlling domestic demand. But over the years you will notice that increasing weight has been placed on policies aimed at improving the performance and allocation of domestic production. Thus, if one looks at a representative batch of arrangements of recent years, only a few of the programs underlying these arrangements could properly be called "demand control" programs. Most programs entailed strategies and policy choices that give considerable weight both to demand and supply considerations.

Of course, improvements in demand management were nearly always called for, and in practice that meant almost invariably efforts at reducing overall budget deficits because these played a major role in the emergence of balance of payments problems. Monetary and credit policies were typically devised to be supportive of fiscal adjustment

rather than by themselves play the primary role in controlling domestic demand. Financial policies also were frequently aimed at increasing the availability of credit to the nongovernment sector or at increasing the total availability of domestic financial savings in support of expanded investment and production.

In recent years, the role of exchange rate policy has attained greater prevalence in adjustment programs supported by the Fund. This has been in line with increasing emphasis on medium-term structural adjustment, and in recognition of the need to shift productive resources to the external (tradeables) sector to alleviate balance of payments difficulties. But, contrary to public perception, exchange rate action that would result in "significant" change of relative prices was not often specified in initial programs. Typically, that type of action was more likely to be part of policy programs coming after a series of abortive or insufficient efforts with more piecemeal types of measures.

Results

There is quite a literature on the MAP including attempts at cross-country testing in a fairly rigorous sense. Those of you interested in this will find a good deal in the Staff Papers published by the Fund. But I am not going into this side of the matter. Instead, I will sketch out a brief summary of what we find in looking back over some years of experience with adjustment programs supported by the Fund. Please note, I do not set this up as a test of success or failure of Fund arrangements. On the other hand, I do not mean to deny guilt by association; the policies implemented by countries in efforts to attain adjustment-stabilization goals are policies we may have encouraged. Their success or failure to achieve the program objectives should properly be held up to us. But that is precisely the trouble: there were not that many countries that did not succeed and did, in fact, implement all the elements specified in their program.

The following points can be suggested by way of a general overview of experience.

1. Most of the countries in the sample experienced large or growing domestic and external imbalances during the period preceding the initiation of adjustment, as reflected in particular in widening external current deficits and, for several countries, in a sharp acceleration of inflation. Another typical development during the same period for these countries was a slowdown of growth.

2. While individual circumstances differed and although external factors contributed to the size of existing domestic and external imbalances, the widening of these imbalances during the period immediately preceding the initiation of adjustment reflected primarily domestic factors. Large or growing fiscal imbalances and overvalued exchange rates clearly were a major source of difficulties in the majority of countries reviewed. Increase in spending was the main factor responsible for the growing fiscal disequilibrium.

3. Reflecting the key role of widening budget deficits in the emergence of initial imbalances the achievement of sustained reduction in these deficits was frequently a prerequisite for successful adjustment. The pattern of fiscal adjustment in the countries reviewed suggests the following observations. First, in most cases, countries which were able to achieve a reduction of the fiscal deficit during the four-year adjustment period reviewed took significant steps to this end soon after the initiation of adjustment efforts. Second, as regards the sustainability of fiscal adjustment measures, reductions in capital spending were best sustained through the entire adjustment period, followed by efforts to increase revenue and reductions in current spending.

4. In many cases, overvalued currencies or complex exchange rate systems had contributed significantly to the size of existing imbalances. Countries which did follow exchange rate policies resulting in a significant improvement in the competitiveness and profitability of tradables following the initiation of adjustment did achieve substantial gains in export performance. However, significant corrective actions in these areas were frequently delayed.

5. Increasing attention was devoted during the period under review to the formulation of structural and other measures in support of members' adjustment efforts. Although structural difficulties only infrequently were the immediate source of large domestic or external imbalances, the large size and protracted nature of these imbalances increased the need for measures aimed at promoting supply, thus relieving the burden borne by adjustment of domestic demand. Results in these areas, however, were frequently considerably less than satisfactory, reflecting in part delays in recognition of problems but also the difficulty of formulating and implementing appropriate corrective policies.

6. Performance relative to adjustment objectives varied widely in the countries under review. More than half of the

countries in the sample achieved lower external current deficits although the extent to which such reductions were either sufficient or sustainable differed widely. Eight of the countries reviewed recorded external current deficits in 1983 which differed from the current balance considered sustainable in their circumstances by less than the equivalent of five percent of GDP. Nine countries experienced rates of consumer price increase in 1982-83 lower than the median for all non-oil developing countries. Performance as regards growth was also mixed: typically, countries experienced a slowdown of growth following the initiation of adjustment efforts; however, those countries which were successful in maintaining or re-establishing a relatively small external payments deficit subsequently achieved a strong recovery of growth. The relatively strong increase of exports for countries in this group made the recovery of growth possible.

7. Inadequate design of adjustment policies as well as incomplete implementation have been important causes of the failure to adjust. Key considerations highlighted in this respect are that the prospects for adjustment were enhanced when corrective policies were directed to the elimination of the ultimate source of the imbalance and addressed simultaneously significant problems in most major areas of policy. Quicker adjustment clearly reduced the risk that subsequent unfavorable developments would substantially increase the size of the remaining adjustment.

ECONOMIC STABILIZATION, STRUCTURAL ADJUSTMENT AND LONG TERM IMPLICATIONS FOR AID PROGRAMS

by C. Stuart Callison

Introduction and Conclusion

This paper considers the basic elements and objectives of the IMF stabilization programs and the World Bank structural adjustment programs, their key policy requirements, and their likely effects on the pattern of development in a typical less developed country. It then considers the legislated focus of AID programs on the "poor majority," the desirable pattern of development in a typical country, given that focus, and the key policy implications of such a pattern, comparing these with the corresponding policies and development pattern promoted by the IMF and World Bank.

By focusing on poverty groups and looking at development constraints from the bottom up, so to speak, AID derives its policy recommendations from a pattern of development designed to alleviate that poverty, as opposed to the more macro-oriented, top-down approach of the IMF and, to some extent, even of the World Bank. There is a strong coincidence between these policies and those of the macro stabilization and structural adjustment programs, and the latter can be seen as helping to set the stage for "growth with equity"; although arguments for market-oriented policy reforms and indigenous institutional development derived from the poverty and equity focus should be more persuasive to political leaders and their domestic constituents than those derived solely from considerations of macroeconomic stability, balance of payments and international creditworthiness.

Economic Stabilization and Structural Adjustment

A. Basic Elements and Objectives

The stabilization programs supported by the IMF are aimed primarily at reducing chronic balance of payments deficits to sustainable levels. This requires attention to the basic causes of the deficit, including domestic demand expansion and price stability, as well as other factors encouraging import demand and inhibiting exports. High levels of domestic demand, relative to the country's own

ability to produce, translate into high levels of import demand, and this often arises from an overly ambitious public investment program (increasing demand for capital goods imports) and/or from high wage rates awarded urban labor unions (increasing demand for consumer goods imports). Cost and price distortions often skew domestic demand away from domestic sources of supply and factors of production, and toward imported commodities, capital goods, and intermediate inputs. These distortions commonly include an overvalued exchange rate, negative real interest rates on credit, high minimum/urban wage rates, and commodity price controls that encourage consumption while discouraging domestic production. Other factors frequently underlying the payments deficits include inadequate export promotion, high and rising debt-service requirements, declining terms of trade, and declining (recessionary) external demand for exports, as well as non-economic events such as drought, storm damage, war and political instability.

Domestic price inflation reduces incentives to save and invest in the domestic economy. When combined with a sticky exchange rate it raises domestic costs and commodity prices faster than import prices, skewing demand toward imports. Inflation itself is usually the result of a more rapid expansion of domestic credit (either, or both, in the public or private sectors) than of savings and revenue collections. It is also affected by subsidies and price controls that encourage consumption together with poor incentives to save and invest in domestic production.

Chronic fiscal deficits (and the consequent inflationary pressures of expanding public sector credit) are usually the result of an inadequate revenue performance in the face of growing public expenditures for public works, social services, an ambitious development program, a bloated and sometimes (though certainly not always) highly paid civil service, and increasing subsidies to public enterprises and to either the consumers or producers of essential commodities.

The World Bank structural adjustment programs are designed to address the more intractable, structural causes of chronic balance of payments deficits, such as high import demand, the low profitability of producing tradable goods domestically, and protected vested interests in import-dependent, import-substitution industries. Typically, high import demand derives from overly generous wages and incomes policies, subsidized consumption, an overvalued exchange rate (which artificially cheapens the cost of imports), large public investment programs

(requiring imported equipment and supplies), low-energy prices, import-intensive investment and production, and inadequate incentives to save (such as negative real interest rates).

While these factors are causing import demand to rise, domestic production of tradable goods (both exports and goods competing with imports) is discouraged by 1) an overvalued exchange rate, which lowers the cost of competing imports and reduces the profitability of export production, 2) a tariff bias favoring the importation of capital and intermediate inputs (over the use of domestic labor and infrastructure, and inadequate research, extension and credit facilities), further reducing the profitability of and thus the incentives to invest in these activities.

Furthermore, many countries have been following active import-substitution policies for the last decade or two, encouraging industrial investment with subsidized credit and favorable tariff treatment of imported equipment and inputs, as well as positive tariff protection against competing imports for the final product. This has encouraged investment in capital-intensive, import-dependent production techniques (instead of in more labor-intensive activities utilizing domestic sources of supply and thereby creating domestic employment). In addition, it has often protected inefficient, uncompetitive industries, dependent for their financial survival on continued high tariffs and trade restrictions. Such industries produced very costly substitutes for final imports, while increasing aggregate domestic demand for imported inputs and equipment.

B. Key Policy Requirements

The IMF focuses primarily on balance of payments management and the related concerns about foreign exchange rate management, foreign borrowing and debt management, and domestic monetary, fiscal and pricing policies. The World Bank goes beyond this to consider longer-term development concerns as well, such as overall development priorities, the size and composition of the public investment program, the more efficient use of resources, employment objectives, income distribution and the pattern of development--and the necessary institutional development to sustain the entire development effort.¹ The key policy areas of concern to these two multilateral agencies include 1) pricing policies, 2) fiscal and debt management, 3) public investment priorities, and 4) institutional development.

Pricing policies include those affecting the foreign

exchange rate and exchange allocations, the tariff structure and other trade restrictions, interest rates, administered prices and wages, and fiscal incentives for particular investment categories.

Fiscal and debt management policies include those for both external and internal debt management, public and private credit expansion and allocation, budget subsidies, and other policies affecting domestic resource mobilization.

Public investment priorities need to be reconsidered, in most countries, in view of the changing international price structure and more limited resource availability. They usually need to emphasize the expansion and support of agricultural and industrial production for export and to replace imports, as well as the development of domestic sources of energy. These concerns, along with "getting the prices right" to provide more appropriate signals for private sector investment, is at the heart of the World Bank structural adjustment programs.

For successful development in the long run, the indigenous institutional capability must exist to support these efforts. Thus the World Bank supports the development of local institutions for economic policy analysis and determination, for planning and implementing public investments, for budgetary planning and management, for tax collection and administration, for debt management, for the management of public enterprises, for export promotion, and to provide essential agricultural and industrial support services.²

C. Effects on the Pattern of Development

This set of reforms should have fairly predictable results on the pattern of economic development in most countries:

1. Pricing policy reforms.

A significant exchange rate devaluation, in terms of real purchasing power parity, would increase returns to those engaged in the production of exports and import substitutes, so long as domestic pricing policies allow the price increases to be passed on to the producer. Since exports in LDC's tend to be labor and land intensive, the returns to those factors of production would tend to rise. More jobs would thereby be created and real market wages would be forced up by competitive forces over time. Farm incomes should also increase. Trade liberalization would force formerly protected industries to become more

efficient or close down, discouraging new investment in similar capital-intensive ventures.

Rising interest rates would tend to discourage more capital-intensive investment and promote employment generation. Higher energy prices would promote energy conservation and encourage development of domestic sources of energy. Higher agricultural producer prices would increase farm household income and stimulate farm employment, as well as production.

Lower administered wage rates would reduce the income of those employees affected, but would eventually result in more employment generation and higher incomes for poor families.

2. Better budget and debt management.

More effective control and allocation of fiscal and foreign exchange resources should allow more effective implementation of development programs, and most of these are designed to create and support more equitable growth patterns.

3. Revised investment priorities.

Increasing the priority for development activities supporting exports and economically efficient import substitutes would also stimulate the use of domestic factors of production, resulting in more rapid employment generation, rising market wage rates (eventually), and higher farm incomes.

4. Institutional development.

Since most governments consider both equity and growth key development goals, strengthening their own abilities to plan and implement development programs and to analyze and determine more appropriate economic policies can be expected to help achieve these general goals over the long run, and to help counter the demands and influence of opposing vested interests.

AID Programs

A. Focus on the Poor Majority

The U.S. Congress has directed AID to identify the poor majority within the countries we assist and to design our assistance programs in ways that will help most governments

alleviate that poverty. In most developing countries the poorest groups are the traditional farmers, landless farm workers, and workers in the rural and urban informal sectors (employed and unemployed). Such groups are not clearly defined, since poor families often rely on multiple sources of income to survive, with some members of rural households seeking urban employment and sending money home, for example, or working part of the year on the farm and part of it in town.

Analysis usually indicates all or some of the following as basic causes of poverty among the major groups of poor households:

- Low productivity and incomes in the traditional farming and informal sectors.
- An insufficient rate of new employment generation in the modern sector.
- Inadequate social and economic services.
- Inadequate availability of food and other basic consumer goods in local markets.
- Inadequate housing and public utilities.
- All of which are exacerbated by high population (and labor force) growth rates.

B. Desirable Pattern of Development

An attempt to deal with these typical causes of poverty must give priority to:

- More rapid growth of agriculture and the relatively more labor-intensive industries producing food and other basic consumer goods, while simultaneously expanding productive employment.
- More rapid growth of industrial and agricultural exports, which also tend to be labor-intensive.
- Increasing the productivity of and returns to traditional agricultural and the rural and urban informal sectors.
- Expansion of low-cost urban housing construction and of public utilities serving poor areas.

- Reducing the rate of population growth.
- Expansion of basic economic and social services.
- Increasing government revenue available to support recurrent costs of essential economic and social services and to allow more investment and better maintenance of basic economic infrastructure.

C. Policy Implications of AID Program Objectives

Certain policies and development priorities can be identified that will facilitate progress in the desired directions. For ease of comparison with the stabilization and structural adjustment policies discussed above, they will be grouped below in the same general categories-- pricing policies, public investment priorities, fiscal and debt management, and institutional development:

1. Pricing policies.

Prices for capital goods and other imported inputs must be raised to reflect the true scarcity value of investment capital and foreign exchange and to eliminate the bias against the use of labor and other domestic factors of production. The domestic currency, which is presently overvalued by the official foreign exchange rates of most developing countries, should be maintained at least at free market values--or better yet, at a slightly undervalued rate--with frequent adjustments to keep up with the changing conditions of international markets and domestic supply and demand, as well as with the divergence between domestic price inflation and the (trade-weighted) average inflation rates of key trading partners. In addition, the tariff bias favoring capital goods and imported inputs should be eliminated, and domestic interest rates should be maintained at positive real levels.

The price for labor, wage rates, should not be artificially raised by minimum wage legislation or government support of labor union agreements, as this reduces the financial incentives for investors to use more labor-intensive production technology, to invest in the more labor-intensive economic activities, and thereby to employ more workers.

Producer prices for food crops, exports and competitive import substitutes should be raised (or better yet, all controls eliminated) and maintained at real domestic values which reflect the true value of the food and foreign

exchange earned and saved to the economy, in order to encourage the maximum expansion of such production to the point where its marginal economic cost equals that value. This is important not only to help reduce balance of payments deficits, but even more to encourage employment generation and improvements in agricultural productivity and income. In most countries this will require action to liberalize both the foreign exchange rate and administered domestic prices.

Higher prices on the use of imported energy--again, through both exchange rate and domestic price adjustments--are needed to encourage conservation of energy use and the development of domestic sources of energy, and the consequent savings in foreign exchange needed so badly by the developing economy. The cost-recovery pricing of public utilities and socio-economic services, wherever possible, is needed to reduce subsidies and the fiscal deficit, thus releasing revenues for other essential public investments, maintenance and services.

These pricing policies are essentially the same as those recommended by the IMF and the World Bank under their stabilization and structural adjustment programs. Arguments for their adoption based on their effects on the equity pattern and sustainability of economic growth should be more persuasive to most political leaders, however, than arguments based primarily on considerations of macroeconomic balance and the country's ability to repay its foreign debt.

2. Public investment priorities.

An equity-oriented development program will normally place high priority on expanding and sustaining relatively labor-intensive activities such as the production, processing, and marketing of food and export crops, basic consumer goods and services, export industries, production in the traditional agriculture and informal sectors, construction of low-cost urban housing, the construction and maintenance of economic infrastructure, the provision of economic services to support these activities, and the provision of social and economic services to improve the health and skills of the labor force.

These priorities are basically in the same direction as those of stabilization and structural adjustment programs; but they go beyond support for export and import-competing activities to emphasize employment generating activities in general, including those in the traditional and informal sectors, urban housing, manpower training and modern

education to support an expansion of the urban workforce, and the reproduction of incentive consumer goods and services.

An equity-oriented development program places even more emphasis on the importance of changing the pattern of development than stabilization and structural adjustment measures aimed primarily at achieving or restoring macroeconomic balance. It recognizes that slower growth in those sectors using more domestic labor and other resources would be better in most cases than faster growth, or even a slower decline, in the import-intensive, capital-intensive industries that do not provide much employment and income for the majority of the people. In this regard, the financial support accompanying stabilization and structural adjustment programs, by allowing governments to prolong the required adjustment period, is sometimes counterproductive, postponing the necessary economic reorientation for more equitable long-run growth.

3. Fiscal and debt management.

Less important government spending and subsidies must be reduced and controlled, and revenues must be increased to a reasonable percentage of GDP, so that higher priority investments in basic economic infrastructure and its maintenance and the provision of essential economic and social services can be funded and sustained. New credit expansion and debt creation must be limited to reduce inflation and provide a better investment climate. Available credit should be rationed among competing economic uses with a positive, market-determined interest rate (which will also encourage higher levels of domestic savings), instead of through administrative approval processes, which invariably discriminate against the small entrepreneurs and those in the traditional and informal sectors.

Equity-oriented development also requires control over foreign debt expansion and debt service levels, to avoid and reduce such scarcity of foreign exchange that it cannot be freely allocated to priority uses in agriculture and the informal sectors, as well as the modern industrial and transport sectors. This will require careful selection among and reduction in large investment schemes requiring large amounts of foreign exchange and better management of already existing debt.

More attention must be paid to the mobilization of domestic resources for labor-intensive and export-oriented investment and for basic government infrastructure and

services--through positive interest rate policies and progressive taxation.

These policy prescriptions are again essentially the same as those of IMF and World Bank programs, but for more persuasive reasons based on equity considerations of the pattern of growth, rather than on the requirement for macroeconomic balance alone.

4. Institutional development.

Strong public and public-spirited institutions are needed to design, explain and obtain political support for an equity-based program, especially since many of the policy, investment and fiscal reforms required will cause at least short-term dislocations and even some hardships for politically articulate vested interests, labor unions, and higher income consumer groups, who have financial stakes in the status quo and who like to import luxury consumer goods cheaply (with an overvalued exchange rate). The success of equitable development programs will depend on strengthening the capability of public, academic and other research and analytical institutions to generate and process basic socio-economic data, to analyze development problems on a continuous basis, to determine and implement better policy and programmatic solutions, and to provide better financial management for the whole effort.

Stronger institutions are also essential to promote and support the investments required in an employment-oriented development program, institutions such as those providing credit and advisory services, research and extension, transport, storage and other marketing services to small entrepreneurs, traditional agriculture, and the informal sectors. Stronger institutions are also needed to deliver the basic education, housing, health, nutrition and family planning services which are essential to the ultimate success of such a development program.

The bottom-up, equity approach to development requires the same kinds of institutional development called for in the stabilization and structural adjustment programs as a first step, a necessary base; but it simultaneously looks for ways to strengthen indigenous institutional capabilities for expanded analysis and planning of development problems, policies and programs on a continuous basis and to support improvements in traditional agriculture, in the informal sectors, and in basic education, housing and other social services.

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1 E. Peter Wright, "World Bank Lending for Structural Adjustment," Finance & Development, Sept. 1980, p. 22.

2 Pierre M. Landell-Mills, "Structural Adjustment Lending: Early Experience," Finance & Development, Dec. 1981, pp. 18-20; and Thomas M. Reichman, "The Fund's Conditional Assistance and the Problems of Adjustment, 1973-75," Finance & Development, Dec. 1978, pp. 40-41.

SECTION THREE:

POLICY DIALOGUE

Clarence Zuvekas

Robert Adler

Richard Green

Robert Rucker

Kiert Toh

RECENT DEVELOPMENTS IN AID
CONDITIONALITY IN THE CARIBBEAN BASIN

by Clarence Zuvekas, Jr.

Introduction*

One of the principal responses of the U.S. Government to the economic and political crises facing the countries of the Caribbean Basin has been the use of the Economic Support Fund (ESF) as a major tool of economic assistance. From a mere \$15 million as recently as Fiscal Year (FY) 1980, ESF loans and grants for the countries of the Basin rose to an average of \$407 million in FY 1982 and FY 1983. In response to the recommendations of the National Bipartisan Commission on Central America (NBCCA 1984), FY 1984 obligations amounted to \$464 million, and a substantially higher figure is expected in FY 1985.

In contrast to today's Development Assistance (DA) loans and grants, which support specific project activities, most ESF resources--especially in the Caribbean Basin--are intended to provide quick-disbursing, balance-of-payments assistance to recipient governments.¹ Thus they constitute a form of what is generally referred to as "program assistance," which may be regarded as loans or grants supportive of a country's overall development program.² Program assistance is not new to AID or its predecessor agencies, but after the 1960s it was little used in the Latin American and Caribbean region until revived a few years ago.

During the 1970s program assistance fell out of favor because of dissatisfaction with its administrative complexity; a feeling that it had not done much to accomplish political objectives; the belief by a new set of policymakers that trade measures would provide more benefits than aid; and the growing interest in the Congress in redirecting aid toward satisfaction of basic human needs in an environment in which rapid economic growth in the region seemed to have reduced the need for program assistance. However, with the onset of the second oil-price shock simultaneously with a period of political turmoil in Central America and the Caribbean, both the economic and political cases for program assistance became much stronger.

Like the balance-of-payments assistance provided by the

International Monetary Fund and the new Structural Adjustment Lending made available by the World Bank, AID program assistance is conditioned upon the adoption by recipient countries of resource mobilization and other economic policies judged necessary to help ensure the success of the economic program being supported. Such programs are often identified as being either short-run or long-run in focus --"stabilization" or "recovery" programs, respectively-- with IMF resources typically associated with the former and World Bank SALs with the latter. The dividing line between the two, however, is a blurry one; this is particularly evident in the three-year programs supported by the IMF's Extended Fund Facility (EFF).

While AID seeks to coordinate its conditionality with that of the IMF and World Bank, AID conditionality is applied in a different context from that of these other agencies because the United States has important non-economic as well as economic objectives in the countries to which it provides program assistance. This means, too, that recipient countries will view AID conditionality differently from that of the international agencies.

In this paper I will attempt to evaluate the experience to date with the program assistance activities initiated a few years ago in the Caribbean Basin and to speculate on the longer-run effects of that assistance.

The Effectiveness of AID Conditionality in the Caribbean Basin: A Preliminary Evaluation

AID's experience with program assistance conditionality in the Caribbean Basin is only a few years old, and any evaluation must therefore be preliminary and tentative. The process of economic stabilization has not been completed, and in some cases there has been little movement toward structural adjustment. Moreover, it is too early to assess fully the effects of conditionality on domestic resource mobilization, particularly in the private sector. Nevertheless, the experience of the last few years has highlighted several key issues regarding AID conditionality, and some judgments about its effectiveness are possible.

In several Caribbean Basin countries, ESF resources and other U.S. economic assistance--including, importantly, PL 480 Title I and Title II food assistance³--have now reached sizeable proportions of the GDP. In FY 1983, total U.S. economic assistance represented between 2.9 per cent and 6.9 per cent of the estimated 1983 GDP in four of the five major recipient countries, with the ESF component in

these countries accounting for between 1.7 per cent and 5.1 per cent:⁴

	Total	ESF
Costa Rica	6.9	5.1
Dominican Republic	0.7	0.1 ⁵
El Salvador	5.8	3.3
Honduras	3.8	2.1
Jamaica	2.9	1.7

The question thus arises, do assistance levels of this relative magnitude enhance the ability of the US government to achieve conditionality objectives? Probably so, other things being equal; but other factors seem to be more important in determining the effectiveness of conditionality than the relative size of U.S. assistance.

In particular, the effectiveness of AID conditionality in leveraging economic policy reforms seems to depend to a considerable extent on the U.S. government's noneconomic policy objectives in a given country. Experience suggests that economic policy reforms will be more difficult to accomplish the more important and immediate are political/security objectives. In one Caribbean Basin country where such objectives are particularly strong and immediate, ESF assistance played a role in inducing that country--with considerable difficulty--to enter into a stand-by arrangement with the IMF; but performance under that arrangement was not satisfactory, largely because of reluctance to implement agreed-upon measures to reduce the fiscal deficit. After ESF assistance to that country was suspended when noncompliance with the stand-by was determined, pressures to resume ESF assistance quickly arose from those responsible for achieving U.S. political/security objectives. Some even argued that the entire undisbursed balance should be released immediately, with only token conditionality, because noneconomic objectives were overriding. At the other extreme, officials elsewhere in the U.S. government argued that no ESF resources should be disbursed until, at the least, the country had signed a new letter of intent to the IMF. Ultimately, several tranches were released with no conditionality, although the country in question did take some modest steps to reduce a fiscal deficit that was running at about ten per cent of GDP. However, the failure to take additional fiscal measures and other appropriate actions has prevented this country from negotiating a new arrangement with the IMF.

The outcome of this case is of importance not only for AID conditionality in the particular country concerned, but also for the effectiveness of AID conditionality elsewhere in the Caribbean Basin, since countries monitor their neighbors' economic relation with the United States and can point to precedents for laxity in the application of conditionality. It has been argued by some economists in AID and other branches of the U.S. government that conditionality should be enforced rather strictly because the failure of countries to implement stabilization programs implies the need for even greater U.S. economic assistance over the long run to maintain economic activity at levels thought necessary to achieve political/security objectives. This is because the failure to implement stabilization programs means no access to IMF resources, no ability to reschedule debts, and probably no access to new commercial bank loans and credits. The political/security response to this argument, of course, is that in the long run we are all dead--or at least communist, which some would regard as worse. This is a legitimate U.S. foreign policy concern, but in my judgment many U.S. policy-makers significantly underestimate the economic costs of failure to achieve economic stabilization. And if U.S. economic assistance were not available in the amounts needed to prevent further economic deterioration in the absence of a stabilization program, the political costs could be underestimated as well. It is possible, too, that the political costs to Caribbean Basin governments of insistence on stabilization policy actions are sometimes overestimated. This is a question best dealt with by political decision makers and political scientists. (The views of a member of the latter group on policy reform will be discussed below.)

There is a good case, then, for the U.S. government to maintain a firm position on conditionality related to disbursement of ESF resources. In the particular example discussed in the paragraphs immediately above the initial outcome of the debate within the U.S. government was to resume ESF disbursements after a delay of about four months, but to release funds in tranches keyed to progress toward reaching a new accord with the IMF. Moreover, the policy dialogue between the U.S. Government and that of the country in question was formally institutionalized. This compromise offered some hope that progress toward economic policy reform would be made, while also being responsive to political/security concerns. But conflicts again arose in this country between ESF conditionality objectives and political/security objectives, and conditionality was waived to allow ESF resources to be disbursed to meet political/security objectives. Earlier, conditionality had

inflow; (4) virtually unifying the foreign exchange market and stabilizing the exchange rate; and (5) reaching debt rescheduling agreements with its public and private external creditors. After four consecutive years of declining per capita GDP (by a total of eighteen per cent), the Costa Rican authorities understandably want to minimize any additional austerity measures. At the same time, they seem to recognize the importance of continuing the stabilization program and initiating structural reforms to facilitate economic recovery. Costa Rica's GDP in 1984 is expected to grow by 3.3 per cent, which makes it the only country in Central America in which per capita GDP growth for 1984 is anticipated to be positive.

The potential of policy dialogue for accomplishing policy reform objectives was emphasized in a recent report prepared for AID by political scientist Joan Nelson (1983) on the basis of five case studies of recent stabilization programs, including Jamaica (1977-82). Nelson argues that policy dialogue and related efforts should be carried out at the sectoral as well as macroeconomic level, "encouraging officials in sectors where AID has been particularly active to recognize links between sectoral problems and macroeconomic measures, for example, the impact of over-valued exchange rates on agricultural incentives" (p.i). Agricultural policy dialogue has in fact become an important part of the negotiations for PL 480 Title I assistance, which has increased significantly in the Caribbean Basin countries in the last few years.

In commenting on the reluctance of countries to undertake stabilization programs, Nelson notes that greater reliance on market mechanisms is resisted in patron-client system because "even far-sighted and personally honest politicians must retain control over the allocation of scarce resources to reward political supporters" (p.ii). She also notes that most major socioeconomic interest groups oppose stabilization measures, while one major group likely to gain from devaluation--producers of export crops and import-substitution foods--tends not be politically organized or potent. Accordingly, Nelson argues that "a strategy combining short run stabilization measures (mainly demand-management and devaluation) with medium-term structural adjustment is more defensible politically, and more likely to gain leaders' commitments" (p.ii). This is precisely the kind of strategy recommended for Central America over the next six years by the NBCCA and accepted by the current Administration. The call for a multi-year aid authorization is particularly important in this context, but the Congress has not been responsive to this recommendation.

been waived in another Caribbean Basin country where the U.S. government has similarly important political/security objectives. Some modest progress toward achieving ESF conditionality objectives has still been achieved there, but this progress has been slower than the country initially agreed to make.

The status of ESF conditionality in Costa Rica was discussed publicly by that country's central bank president, who noted in early March 1984 (prior to his resignation) that AID has suspended (ESF) disbursements because the IMF stand-by which expired on December 19, 1983 had not been replaced by a new IMF arrangement. Costa Rica was thus seeking bridge financing of \$50 million from various governments to meet its immediate payments obligations to foreign commercial banks. This sum, it was said, would be repaid within three months, by which time Costa Rica expected to have entered into a new arrangement with the IMF and thus would be able to draw again on both IMF and AID (ESF) resources. Agreement had been reached with AID on the terms (i.e., conditionality) of U.S. economic assistance, the central Bank president said, but he provided no specifics. Shortly thereafter Costa Rica did submit a draft letter of intent to the IMF and received \$50 million in bridge financing from Mexico. However, Costa Rica and the IMF later had to renegotiate the terms of the proposed new arrangement, and it was not until November that a revised draft was submitted, with Costa Rica hoping for IMF Board approval of a stand-by in December. Costa Rica is also well along on negotiations for a World Bank SAL.

The current Costa Rican situation suggests that AID conditionality, and specifically the condition that a country adopt and follow an IMF-supported stabilization program, can be effective when large amounts of U.S. assistance are being withheld (the central bank president, in his statement in March, mentioned an estimated \$130 million in AID assistance) and U.S. political/security objectives are not urgent. On the other hand, the fact that Costa Rica did not enter into a new IMF arrangement as soon as the old one expired is a sign that the country was unwilling to accept without discussion whatever conditions the IMF (and AID) initially proposed. Negotiations have not been easy, despite the fact that, under the previous IMF stand-by, Costa Rica succeeded in (1) reducing its budget deficit from 9.1 per cent of the GDP in 1982 to 4.5 per cent in 1983; (2) bringing the annual inflation rate (wholesale price index, December to December) down from 117 per cent in 1981 and 79 per cent in 1982 to only six per cent in 1983; (3) converting a short-term private capital outflow into an

While the amount of aid provided is, as noted above, an important consideration in determining the effectiveness of conditionality, Nelson's study led her to "a tentative generalization. . . that skillful persuasion may be more important in winning initial acceptance of difficult reforms than is partial compensation. The major role of compensation may be to induce continued acceptance, during the months and years needed for the reforms to have the intended effects" (1983:iii). This conclusion supports the recommendation of the team evaluating AID's experience with program assistance in the 1960s (U.S. AID 1970), that AID have appropriately qualified Mission Directors and good economic staffs in countries where macroeconomic policy dialogue is being carried out.

Nelson's finding also suggested that "shock" treatments are more politically acceptable than gradual adjustments, since public tolerance for reforms is brief. "Both the public and political leaders may be better able to accept a well-explained sharp cut followed, if necessary, by some easing of the burden via partial compensation for the groups that have been most affected, or are most politically relevant" (p.iii). Most Caribbean Basin countries, however, have been unwilling to accept such treatments. Costa Rica is an exception, but even there the extent of economic and financial liberalization had been far from complete.

Another of Nelson's findings, interestingly, is that persuading labor to accept belt-tightening may be easier than persuading the business community to redirect its energies (p.iii). This suggests that AID's current effort to negotiate conditionality through policy dialogue with governments should be complemented by greater attention to direct dialogue with business sectors--some elements of which stand to lose, initially at least, from a more externally-oriented growth strategy--to explain the rationale for the structural adjustments. A recent AID study of economic liberalization in Sri Lanka, Egypt, and the Sudan concluded that "the extent of liberalization achieved was largely dependent on the political and economic interaction between the governments and those groups that stood to lose from the liberalization" (Morrison and Arreaga-Rodas 1981:6)

With respect to belt-tightening by labor, Gary Fields (1982) has argued on the basis of a comparative study of four East Asian and three Caribbean countries that, over the long run, "employment and income distribution conditions improved most rapidly in those economies where wage policy

was 'strict' and economic growth was rapid [i.e., the rapidly growing East Asian countries]; . . . employment and income distribution conditions improved less rapidly or even deteriorated in those countries where wage policy was 'lenient' [i.e., the Caribbean countries] and economic growth was slow" (p.3).⁷ Fields regards "the differences in wage-setting processes--supply and demand in the East Asian NICs, institutional wage determination elsewhere--as a major reason for their differential rates of economic success" (p.15). Note that the focus here is on the wage-setting process rather than on temporary belt-tightening. If, as economic recovery begins in the Caribbean Basin, the wage determination process is again strongly influenced by institutional factors--particularly important in Costa Rica and Jamaica among the major ESF recipients in the Caribbean Basin--economic recovery through export-led growth may not be as rapid as AID and the countries themselves hope. In other words to the extent that Fields' generalization is valid--we do not yet have enough evidence to be strongly confident about the relationships he has observed in seven countries--lenient wage policies may discourage investment.⁸ Even if this were true, however, this is a sensitive policy area that may be inappropriate for AID conditionality. Nevertheless, AID is formally discussing wage policy with at least one Caribbean Basin government.

A Concluding Note

During the 1980s AID has sharply increased its program assistance to the countries of the Caribbean Basin in the form of ESF loans and grants.⁹ In most cases this assistance has been conditioned in part on the adoption of stabilization programs acceptable to the IMF. AID has sought to supplement this requirement with additional conditions precedent to disbursement and/or less-binding covenants under which governments agree to undertake other economic policy reforms, especially of a structural adjustment nature.

In this connection it is important to bear in mind the recommendation of the evaluation team reviewing AID assistance in the 1960s (USAID 1970) that policy conditions be kept few in number. While it can be argued that comprehensive conditionality will help ensure consistency of policy measures and thus make success more likely, each element of conditionality has a political price. Nelson's conclusion (1983:iii) that economic shock treatments may be more acceptable politically than gradual adjustments does not seem to be shared by most political leaders in the Caribbean Basin. The most notable recent example of the

application of the shock treatment in the Latin American and the Caribbean (LAC) region offers little comfort: whether or not one should blame Chile's current problems on the application of the Chicago boys' prescriptions (rather than their misapplication or incomplete application), the conventional wisdom in the region has so placed the blame.

This is not to argue that shock treatments are always desirable, or even that less-shocking but still strict IMF conditionality packages are always good second choices. The high rate of prematurely terminated IMF arrangements in the LAC region in recent years suggests that IMF conditionality --and by implication AID conditionality, even without the extra conditions--has often been regarded as too strict to be acceptable politically. This is not the place to debate IMF conditionality,¹⁰ but the issue can at least be raised whether longer periods of economic adjustment might be desirable in the Caribbean Basin in view of the depth of the economic crisis, the poor prospects for economic recovery via traditional exports, and the investment-inhibiting political uncertainties in much of the region.

The process of structural adjustment under these circumstances is likely to be a long one. While there is a growing recognition among economists and political leaders in the region that export diversification is desirable, exchange rate adjustment--perhaps the most important economic measure for accomplishing this objective--continues to be strongly resisted. Nevertheless, all countries have taken some export promotion measures, and overall progress in this direction may have been greater than the prevailing viewpoint that AID admits. The lack of responsiveness to date of nontraditional exports may be due in large part to the continued sluggishness of world trade generally until 1984, and to unsettled political conditions in Central America. Even if these two constraints are relieved, however, other barriers to structural adjustment may remain. Fields' (1982) comments about wage policy are of particular concern in this respect.

Finally, it should be borne in mind that the effectiveness of AID conditionality will depend to a large extent on how much can be shielded from political/security concerns. One strategy might be to ask for fewer elements of conditionality but to insist more strongly on these elements even in the face of short-term political/security arguments. An advantage of this strategy would be that AID would have to relinquish or soften fewer conditions and covenants in the face of unforeseen circumstances, thus strengthening the credibility of its conditionality. Thus

far in the 1980s AID has been able to preserve a higher degree of conditionality than might have been expected. Whether this remains true as events unfold in the Caribbean Basin remains to be seen.

Footnotes

* The views expressed in this paper are my own and should in no way be interpreted to represent the policies of the Agency for International Development or any other part of the U.S. Government, except when explicit reference is made to a policy statement or document. I would like to thank Tonya Creek for research assistance and Robert Adler, Frederick Berger, Gary Fields, John Olsen, and Neal Riden for comment on the earlier paper (Zuvekas 1984) from which this updated extract is taken. None of these persons is responsible for any remaining errors of fact or interpretation.

¹ A small percentage of ESF resource flows to the Caribbean Basin in the last few years has supported specific project activities. But for all practical purposes we can regard all recent ESF resource flows as program assistance, though it is possible that a greater share may be "projectized" in the coming years. In the 1960s, DA resources were used for program assistance as well as project activities.

² I use the term "program assistance" in a generic sense, not in the more narrow sense in which it was once used within AID. The new ESF flows to the Caribbean Basin, it might be noted, are generally not referred to as program assistance by AID officials.

³ Significant conditionality has sometimes been attached to Title I assistance, particularly aimed at the elimination of price controls on basic grains and other commodities, a reduction of government involvement in agricultural production and marketing, and the elimination of subsidized interest rates. There have been some successes in achieving these policy reforms, but a detailed review of PL 480 conditionality is beyond the scope of this paper.

⁴ Based on official exchange rates. Since most if not all of these countries had overvalued currencies in 1983, the relative importance of ESF assistance was even greater than indicated by these figures if local-currency GDP is converted to dollars at more realistic exchange rates. Conversion of ESF dollars, however, is at official exchange rates.

⁵ In FY 1982, however, ESF assistance accounted for 0.5 per cent of the Dominican Republic's GDP.

6 See La Nacion (San Jose), 3 March 1984.

7 The three Caribbean countries studied were Barbados, Jamaica, and Trinidad-Tobago, of which the former was judged to have "moderate" wage policies. The four East Asian countries were Hong Kong, South Korea, Singapore, and Taiwan. Fields admits that his sample is small but concludes that "the evidence seems to suggest strongly that the associations are not merely coincidental."

8 Indeed, Fields hypothesizes (1982:22) that an export-oriented development strategy combined with a lenient wage policy may harm a country's development effort.

9 The issue of loans vs. grants is one I have not discussed in this paper. Some AID Mission Directors maintain that grant assistance can be monitored more closely than loans and is also better for achieving conditionality objectives. Others in AID, however, are concerned that grant assistance can create the illusion in a recipient country that fiscal disequilibria are being corrected.

10 In this connection see Buirra (1983) and various essays in Killick, ed. (1982) and Williamson, ed. (1983).

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POLICY DIALOGUE AND ECONOMIC RECOVERY IN COSTA RICA:
LEVERAGE AND GUILE IN A DEMOCRACY

by Robert W. Adler

The Pre-Stabilization Situation

In the period 1978-1982, the Costa Rican Government engaged in large external borrowing, mainly at commercial rates, to maintain a fixed exchange rate, compensate for the fall in the value of exports, and cover what was hoped by some to be temporary balance of payment deficits. Costa Rica's balance of payments current account deficit amounted to \$1.6 billion in the three-year period 1979 through 1981 and was financed by \$1.7 billion increase in outstanding public sector external debt. Despite such strong commercial bank assistance to maintain a fixed exchange rate, the Carazo administration suspended service of external debt in August 1981, and at the end of the 1981 the Costa Rican economy was afflicted by inflation running over 100 per cent per annum, a continuous devaluation of the colon, which during the previous eighteen months had amounted to 319 per cent, a severe shortage of working capital, and rising open unemployment. The accelerating inflation and exchange depreciation had been caused in the first instance by growth of domestic credit from 35 per cent per annum in 1978 to 105 per cent in 1982 and secondly by exhaustion of foreign exchange reserves in the second half of 1980. With the erosion of working capital in real terms and increased difficulty of importing, growth of Gross Domestic Product (GDP) slowed to 0.8 per cent, and subsequently declined by 2.3 per cent in 1981 and 9.1 per cent in 1982.

Even though the Carazo administration attempted stabilization programs, notably a self-imposed program in 1979, a formal IMF Standby agreement in 1980, and three-year IMF Extended Fund Facility in June 1981, in each the targets were soon missed and the program abandoned. However, some progress was made on the fiscal front by adoption of an instrument which gave the Executive stronger control over spending by the decentralized public sector. By the time the Monge administration took office in May 1982, most elements of Costa Rican society were aware of the deteriorating economic situation and sufficiently alarmed to make possible the imposition of the discipline of a stabilization program. In October 1982, the Government reached agreement with the IMF on a comprehensive

stabilization program, and this program was formalized December 20, 1982 in a one-year Standby arrangement which amounted to SDR 92.5 million.

The Stabilization Effort of 1983

The stabilization program supported by this Standby was designed to reduce inflationary pressures, to promote orderly exchange markets, and to facilitate resumption of public sector external debt service. On January 10, 1983 the GOCR reached agreement on a bilateral debt rescheduling under the aegis of the Paris Club with ten creditor countries which rescheduled principal and interest in arrears and falling due between July 1, 1982 and December 31, 1983 to a seven year period beginning December 1985. On April 22, 1983 the GOCR signed a memorandum of understanding with foreign commercial banks, covering all principal in arrears and falling due in 1984. These payments were rescheduled to a period beginning in 1987 and ending in 1991. In addition, the agreement provided a revolving credit fund in favor of Costa Rica, but of self-liquidating and diminishing character, composed of fifty per cent of the interest payable and due in 1983.

Apart from debt service relief, IMF and U.S. assistance approximating \$250 million supported Costa Rica's 1983 balance of payments and was crucial to GOCR efforts to bring about exchange rate stability and to reduce inflation. By the end of 1983 the consumer and wholesale prices indices were increasing at annual rates of only 10.7 per cent and 5.9 per cent respectively. In addition, the five colon spread that had existed between the inter-bank market and "free" bank market exchange rates was eliminated during the course of 1983. The major Costa Rican Government contribution to the stabilization program consisted in reduction of the public sector deficit. This deficit had increased from 6.7 per cent of GDP in 1977 to a high of 14.3 per cent in 1981 and was reduced to 9.1 per cent in 1982, 4.5 per cent in 1983, and to an estimated 2.5 per cent in 1984. Reduction of the deficit can be attributed in part to expenditure cuts that began in 1982 as well as to increases in the charges of the state-owned petroleum refinery, public utilities, social security contributions, and taxes in general. Private sector purchases of government securities were a major source of financing of the public sector deficit in 1983.

The 1982-1984 ESR (B/P Assistance) Programs

In Costa Rica, the annual ESF programs bear the title

Economic Stabilization and Recovery (ESR) programs, with vintages, thus far, as ESR I (FY 1982), ESR II (FY 1983), and ESR III (FY 1984). The ESR Programs are balance of payments support, aiming at increasing the availability of both foreign exchange and local currency credit to the private sector. During the three year period 1982-1984, ESR disbursements to Costa Rica have approximated ten per cent of commodity imports (CIF) and 32 per cent of the B/P current account deficit. ESR I provided \$20 million, ESR II provided \$155.7 million, and when fully disbursed ESR III will provide \$130 million. Thus the ESR program has been a key ingredient in limiting erosion of per capita consumption while simultaneously permitting Costa Rica to resume interest payments on public sector external debt. Even so, in 1983 private consumption per capita was 21 per cent below the 1977 level.

Conditionality and Leverage

ESR programs have been tied in varying degree to attainment and compliance with IMF arrangements. For example, the 1983 program was conditioned upon Costa Rica's entering into and remaining in compliance with Standby arrangement with the IMF and contained a disbursement schedule by months and a specific provision as follows: "AID reserves the right to suspend scheduled monthly disbursements in the event that the GOOCR is not in substantial compliance with the IMF Agreement as determined by AID." In late 1983, AID suspended disbursements to Costa Rica but without direct linkages to IMF conditionality. Specifically, in November 1983, following a revaluation of the "free" bank exchange rate from 43.6 colones to 42.6 colones to the dollar. The Mission opened a dialogue with the Central Bank under a covenant of the Agreement which required the Central Bank "to maintain a policy which does not weaken the competitive position of Costa Rican exports in foreign markets." Some weeks later the IMF suspended disbursements after it determined that Costa Rica was maintaining a tax on foreign remittances which contravened the IMF Standby. The IMF and AID resumed disbursements once the GOOCR had undertaken a five per cent devaluation of the colon and legislative action to remove the tax on remittances.

Even though progress toward stabilization was generally satisfactory in 1983, GOOCR willingness and ability to continue such a program were open to doubt and both the IMF and AID applied pressure in 1984. The GOOCR's public sector budget proposal for 1984, submitted to the Legislative Assembly in October 1983, had a projected deficit (fifteen

billion colones), and the IMF held that this was about three times the amount otherwise compatible with economic stability in 1984. The IMF refused to discuss a new Standby arrangement until the GOCR agreed to reduce the projected deficit and such legislation was approved in February 1984. Even though the IMF negotiations of March 1984 produced a mutually acceptable Letter of Intent for a one year Standby arrangement, the IMF included nine "prior action" whose completion were required prior to submission of the Program to its Executive Board. However, implementation of these measures suffered delays due to departure in March of the Central Bank President (and leader of the economic team), which created a vacuum that was not filled until August. By mid-1984, the fact that imports were running about twenty per cent higher than one year earlier also signalled the need for corrective measures to dampen aggregate demand and imports. In June, the Monge administration tightened credit conditions, and by early September it had also approved several tax and fiscal measures to reduce the fiscal deficit, thereby meeting conditions set by the IMF to resume negotiations for a "re-drafting" of the 1984 Letter of Intent. These negotiations resumed in early September, and agreement in principle on an essentially new fifteen-month Standby was reached in late October.

In regard to AID leverage, the ESR III program required as a prior action legislative approval of amendments to the Currency and Central Bank Laws, respectively, to facilitate dollar dominated lending by all credit institutions and to permit direct private commercial bank access to Central Bank credit operations. The Currency Law, as interpreted by Costa Rican courts, had allowed many debts denominated in foreign currency to be repaid in Costa Rican currency at the so-called official rate of twenty colones to the dollar rather than at the bank rate, which by 1983 was over twice as high. Thus, without amendment to overturn the existing legal interpretation, dollar denominated lending could not be restored in Costa Rica even to support export-related activities, and such interpretation was responsible, in part, for holding up dollar disbursements on two DA-funded projects to make dollar credit available to exporters--COFISA (0187) and BANEX(0176). The Central Bank Law amendment enables direct access by private banks to Central Bank credit where the origin of the funds is external. Inasmuch as a substantial portion of Central Bank credit to commercial banks derives at present from external sources and is likely to continue to do so in the future, the exclusion of private commercial banks from this credit perpetuates discrimination against these banks and favors the state-owned commercial banks, particularly in view of

their legal monopoly on demand deposits. Even though President Monge, his economic team, and a majority of the Liberacion Party in the Legislative Assembly favored passage of these amendments, a minority faction of the Liberacion Party and of radical leftist used several parliamentary tactics to block their passage in a struggle that endured from April until legislative approval on August 19, 1984. The refusal of AID to disburse ESF monies during this period was widely advertised, castigated by some Deputies, and used as leverage by the advocating Deputies and President Monge to secure approval of these reforms.

The Dialogue Experiment Paper: "Strategy and Actions 1984-1986"

By the second half of 1983, USAID/Costa Rica recognized that it was neither practical nor desirable to continue to make ESR agreements solely with the Central Bank instead of the Government because many of the reforms we desired lay outside of the legal mandate of the Central Bank. In its deliberations, the Mission also gave serious consideration to the pros and cons of crafting ESR Agreements so that they would require ratification by the Legislative Assembly. Since most structural reform measures would require legislative action at some point in the process, it could be argued that legislative ratification would provide cognizance of the reforms by that body, and something of a commitment to take positive action when proposals were presented to it by the Executive. The Mission finally decided against legislative ratification for the following reasons, "The uncalculable delay factor that is implicit in such a procedure; and more importantly, the certainty that an open debate would ensue in which the U.S. would be charged with interference with national sovereignty, unfavorable headlines in the press, and perhaps a demagogic refusal to ratify as an end result. The Currency Law experience of 1984 suggests that we should hold the entire ESR program hostage to legislative approval only if needed to obtain impressive and urgent reforms and if substantial Costa Rican political support is available.

With the shift in emphasis toward structural reform, the Mission also undertook a broader policy dialogue. Key GOCCR officials agreed in August 1983 that it would be preferable for the GOCCR to take the lead in formulating and proposing needed structural reforms and policy changes. AID could then support these proposals, rather than have them take the form of U.S. imposed conditions. As a result, the GOCCR created an Interministerial Commission composed of the President of the Central Bank (and leader of the Economic

Council), the Ministers of Planning, Finance, and Exports and Investment, to prepare a concepts paper on economic policy strategy and actions required during the years 1984-1986. This document, entitled "Strategy and Actions in Economic Policy, 1984-1986," (hereinafter cited as the SAP) went through several drafts from its initial preparation by Central Bank technicians, to its review by the Commission, their alterations and approval, and presentation in May to President Monge. AID provided views for the initial draft and during the approval process, and the Mission was well satisfied with the early versions of the SAP. At the level of the Presidency, the initial reaction was positive concerning the substance of the document, but reportedly adverse reaction by some Ministers dashed hopes for eventual cabinet approval.

As the SAP document progressed, its content became watered down and in retrospect one can see a certain degree of beguilement at the prospect of a Government public commitment. The policy areas of the SAP included money and credit, fiscal, prices, wages, exchange rate, foreign trade, and export/investment promotion. The final Commission commitments are listed by policy area below, and such revisions or eliminations which occurred in the drafting/discussion process are as cited:

Monetary and Credit Policy. The Commission recommended an attempt be made to have positive real interest rates, a simplification of interest rate structure, the holding of subsidized credit to a low volume, and to a mixed banking structure. The Mission's desire for a strong commitment to positive real interest rates and to limiting the specific areas for directed credit to only five was not adopted by the Commission.

Fiscal Policy. The Commission made a commitment to avoid an increase in the public sector deficit as a ratio of GDP, to avoid inflationary finance, to reduce port and other charges affecting exports by 2.2 billion colones, to improve tax administration, and it promised to reduce public sector expenditures by means of a freeze on public sector employment, the elimination of unessential programs, improved expenditure controls and a more prioritized public sector investment program.

Price Policy. The early drafts included commitment to a thorough examination of the method of fixing prices for goods produced by the public sector or receiving government subsidy and for a reduction in the number of goods subject to price controls and in support prices (mainly on

agricultural commodities). This commitment was eliminated and does not appear in the Commission draft. However, the provision for such a study was included as a covenant in the ESR III agreement with the GOCR.

Wage Policy. Early version statements indicate that the minimum wage (including fringe benefits) would remain constant in real terms; later versions state that wage policy contemplates a gradual recuperation of the decline in real income registered in recent years.

Exchange Rate Policy. The Commission made a commitment to maintain a flexible exchange rate policy taking into account basically, but not exclusively, four elements: the supply and demand for foreign exchange, the prospects for the balance of payments, the competitiveness of exports, and the relation between domestic and foreign prices. Early draft statements subscribed to a monthly-adjusted crawling peg.

Tariff Policy. The Commission made a commitment for a reform of import tariffs to effect a reduction of effective protection to improve the competitiveness of Costa Rican products in international markets and to this effect bills would be submitted to the Legislative Assembly for (1) a complete revision of the import tariff schedule to reduce its dispersion along the lines of the SIECA proposal; and (2) the gradual elimination of the tariff exemptions on imports excepting those used for production of exports. In addition, a commitment was made to negotiate elimination of surcharges imposed pursuant to the San Jose Protocol of 1970.

Foreign Debt. The Commission made a commitment that the public sector would not undertake negotiations for new loans without authorization of the Ministry of Planning, which would give approval based upon the social usefulness of the project and the debt service capacity of Costa Rica and the borrowing entity.

Export and Investment Promotion. The early drafts of the SAP contained nearly a score of specific measures, and the final Commission SAP set out several measures that would help exports but without a timetable for their implementation.

In summary, the SAP exercise was useful for consolidating and defining GOCR economic policy, at least at the level of the Economic Team. However, the results were disappointing in view of our investment of about two person

years in the dialogue. The aim, even if eventual, of obtaining full cabinet-level consent to the SAP served to make stated commitments less specific and weaker. We suspect, moreover, a SAP fully supported and publicly proclaimed by a Costa Rican government, would not come to exist without political leadership which felt a strong mandate for economic reform.

The Dialogue Environment

Costa Rican Democracy. The fact that the Costa Rican President cannot have more than one four-year term and that legislators cannot have consecutive four-year terms deprives the electorate of the opportunity to reject a regime, and this may decrease efforts of an administration to undertake decisions which have pay-offs beyond the next election. The Monge administration economic team has had discontinuities, the President himself is not a trained economist and has not engaged an economic czar, and at times some individuals on the economic team have opposed elements of the stabilization program. Over the past three decades, the rewards of political loyalty have enlarged public sector employment to one-fifth of the employed labor force, and the government has engaged in and subsidized business activities and done so with substantial financial and economic loss.

U.S. Foreign Policy Interests. Given the present Central American context, the U.S.G. has been guided in its treatment of Costa Rica mainly by a desire to restore economic stability and growth. Moreover, at critical moments, U.S. Mission leadership has also resisted elimination of inconvenient economic conditionality for transitory political gain. I believe that ESF resources are not provided to Costa Rica in exchange for political and military favors, but that the very substantial magnitude of these resources in recent years reflects principally an area of broad yet unique agreement in an otherwise turbulent U.S. Congressional struggle on assistance levels in the region. The dangers are that we may fill Costa Rica's present balance of payments shortfall so adequately that we reduce the felt urgency of Costa Ricans policy makers for export expansion and that we abandon the program before export expansion occurs.

The Crushing External Debt. The very large size of Costa Rica's debt service, with interest payments on public sector debt amounting to \$360 million in 1984, or about 37 per cent of export earnings precludes B/P relief via any substantial expansion of net lending by commercial banks. Even though this situation is common in post-Mexico-

debt-shock Latin America, the options seem starker for Costa Rican policymakers than elsewhere. They are (1) default on debt service and do without the tutelage that accompanies IMF and ESF assistance as well as the relief of debt rescheduling and endure several years of creditor retribution and eventual concession or (2) pay interest and continue a negotiation process that may become more distasteful with experience. I suspect that it would be appropriate for external donors to treat the sub-group of the genuinely bankrupt Latin American countries according to an absolute standard of performance rather than according to a precept of perpetual betterment.

The Role of the IMF. The Costa Rican external payments situation requires continuing arrangements with the IMF mainly to facilitate the rescheduling of external debt. IMF arrangements are also a useful guarantee of the economic stability desired by the U.S.G. and they can be a useful mechanism for the GOCR in addressing domestic critics of economic policy. In 1984 the prolonged absence of an "in force" IMF arrangement hurt domestic advocates of stabilization and deprived policymakers of effective leverage to counter performance shortfalls. This problem arose from the IMF's imposition of "prior actions" which required Legislative approval as well as technical shortcomings in the Standby arrangement (i.e., the quantitative ceilings on credit expansion were insufficiently restrictive). In addition, the second-round Standby negotiations were marred by delay related to quibbling on the trade-off between exchange devaluation and the public sector deficit. At this juncture it is impossible to know whether the IMF is not treating client countries equally, as alleged by some Costa Ricans, or whether the IMF is acting merely as a tougher Central Banker once a major liquidity crisis has become less threatening.

The Role of the IBRD. The IBRD is contributing to the dialogue environment through on-going negotiations for Structural Adjustment Loan. The legislative struggle for reform of import tariffs is slated to begin in December and the amount of external resources for the anticipated three-year SAL program is on the order of \$200 million.

The Role of Studies/Education

We consider studies and education on economic issues to be decisive in the long run. The Mission has financed investigative studies on effective tariff protection, pricing policies, the supply and cost of credit, constraints to exporting, and on CODESA (the state business holding

company), and it has financed educational studies on such topics as the fear of adjusting, Central American economic integration, and annual macroeconomic updates. Costa Rica's recent economic crisis has demonstrated that its economic structure and certain of its institutions are not the most appropriate for economic growth. Unfortunately, the belief that the free operation of market forces is not the most appropriate and that government has to intervene and participate actively in most areas of the economy, and that some public sector institutions are untouchable prevails for a sizeable segment of Costa Rican politicians. Recently, the Mission economists have recommended and received Mission approval of a subsidy with resources available to USAID/Costa Rica for publication for each of the two major political parties of their diagnosis of the country's economic problems and their strategy for overcoming these problems.

U.S. PROGRAM ASSISTANCE AND POLICY DIALOGUE IN KENYA 1980-1984

by Richard Greene

Introduction

U.S. foreign policy interests and AID program assistance have been closely linked in Kenya since the beginning of the present decade. A \$17 million PL 480 Title I program was introduced in FY 1980 in the face of serious grain shortages. A complementary \$20 million Fertilizer Import Program was also introduced, in part to address the grain problem, and in part to meet balance of payments and budgetary deficits of a magnitude unprecedented for Kenya. The level of U.S. assistance to Kenya jumped sharply in 1980 in response to these needs, and coincident with increased access by U.S. ships and planes to Kenyan ports and airfields at a time of heightened U.S. policy interests in the Middle East. Program assistance played no part in total U.S. assistance to Kenya in U.S. FY 1979. By FY 1984 such assistance accounted for more than forty per cent of all U.S. assistance. USAID/Kenya has utilized Development Assistance (DA) funds to provide program assistance in both commodity and cash grant form. USAID/Kenya has, in addition, utilized Economic Support funds to provide significant levels of policy related technical assistance to Kenya.

U.S. Program Assistance to Kenya: 1980-84

	1980	1981	1982	1983	1984
PL 480 I	16.9	16.0	15.0	15.0	5.0
Fertilizer	14.5	5.5	4.4	-	15.0
Cash Grant	-	-	10.7	30.0	-
CIP	-	-	-	-	19.0
Total	31.4	21.5	30.1	45.0	39.0

Policy Dialogue and Program Assistance

Policy dialogue and program assistance became linked in Kenya in FY 1982 under a \$4.4 million Fertilizer Import Program, and under a \$10.7 million emergency Cash Grant which followed the abortive coup attempt against the

government of Kenya's President Moi on August 1, 1982. Small steps toward privatization of fertilizer marketing in Kenya were taken as a result of the FY 1982 Fertilizer Program. The FY 1982 Cash Grant, however, served largely as a political gesture, although the project agreement contained language on improved export promotion which added to IMF and World Bank pressure on the Government of Kenya to continue devaluation of the Kenya Shilling, to modify the trade regime, and to simplify export documentation and procedures. The FY 1982 Cash Grant established an important principle, allocating approximately one half of the local currency resulting from the \$10.7 million grant to the private sector to rehabilitate businesses which had been damaged in the August coup attempt.

Policy dialogue and program assistance became more tightly linked in FY 1983 with the signing of a \$28 million ESF-funded Cash Grant, and an associated \$2 million Technical Assistance Program Grant. This ESF-funded program was amended in FY 1984 with the addition of a \$13 million Commodity Import Program (CIP), and an additional \$6 million in technical assistance funds. The switch from a Cash Grant in FY 1983 to a CIP in FY 1984 in part reflected USAID disappointment at the slow pace of implementation of some conditions precedent and covenants of the 1983 Agreement. The tripling of the technical assistance component, however, reflected both the increasing Kenyan demand for policy related studies, consultancies, and technical assistance, and USAID's assessment of the success of this approach in bringing about implementation of announced policy reforms. FY 1984 saw an expansion of the private sector component of U.S. program assistance to Kenya with agreement that CIP generated Shillings equivalent to \$5 million would be earmarked for private sector programs in agricultural, export, or housing credit.

Conditions and Covenants

USAID policy dialogue in FY 1983 and 1984 revolved around the conditions and covenants contained in ESF-funded program assistance, and around the related FY 1984 Fertilizer Program funded with DA resources. PL 480 Title I discussions have played a limited role in advancing policy dialogue objectives in Kenya for a variety of reasons. Individual projects in agriculture, health, population, and private enterprise development have all had policy components and implications, but these are too numerous, limited, and at times too indirect to discuss here.

The FY 1983 ESF-funded Program Grant contained seven

conditions precedent and seven covenants on various issues, each of which is reviewed briefly on this page.

1. Export promotion has been encouraged by two significant and several minor devaluations since 1980 and by some simplification of export procedures. An export incentive scheme provides a 15 per cent bonus on selected export products. Promotional programs, including an additional ten per cent bonus on incremental exports, have been proposed, but no new ones have been implemented.

2. Budget and credit targets. The government of Kenya met all IMF and related USAID budget and credit targets in 1983, and through October 1984.

3. Import administration is improving slowly following establishment of new import schedules for 1983-84. The first FY 1983 covenant gives emphasis to further reform of import procedures and to movement toward a more uniform tariff structure.

4. Agricultural inputs were shifted to the Schedule IA "free list" except for fertilizers and pesticides, which were placed on Schedule IIA Special where they require ministerial review for quality, quantity, and type. Fertilizer importation, however, has not been constrained by limitations on available foreign exchange.

5. Improved administration of fertilizer importation and distribution. The government has established a Fertilizer Advisory Committee with both private and public members. The Committee has met to confirm public sector estimates of the required types and amounts of fertilizer imports, to establish prices, and to approve private sector distributors. The government's agreement with the Kenya Farmers Association, giving the latter monopoly rights to distribute donor-supplied fertilizers, has been terminated. (Under the FY 1984 \$15 million Fertilizer Program a system of private sector importation of fertilizer under private bank guarantee of payment to Treasury has been expanded from the U.S. fertilizer program to those of all other donors.)

6. Public investment planning and establishment of investment priorities. Assistance from the World Bank was required before the government of Kenya could fulfill its commitment under the Bank's Structural Adjustment Loan (SAL II) to complete a forward budget and public investment plan. A similar commitment had been made to USAID under the FY 1983 ESF Cash Grant. The 1984-88 Development Plan does not adequately reflect curtailment or deletion of projects for

which commitments have already been made, nor does it delineate the criteria used to select new investment projects proposed for the Plan period. The government of Kenya has now announced the criteria for including projects in its annual budgets, however. These include positive economic and social benefits, full funding, foreign exchange impact, and impact on recurrent costs. The government is beginning to computerize donor project data, and to relate these data to external debt and to the forward budgeting process. In accordance with the third FY 1983 covenant, the government is now giving high priority to strengthening the budget process. Computerization of donor project data is an important step forward toward meeting the fourth FY 1983 covenant to improve the management of externally financed investment.

7. Food security. Following completion of food policy studies, the government of Kenya is taking steps to strengthen emergency food reserves, and with great reluctance and misgivings, to reduce its role in grain marketing and food imports. Because of the current drought, food security is being addressed in a crisis atmosphere without adequate attention being given to strengthening market and information mechanisms. Marketing controls are seen as a public responsibility ensuring urban price stability, preventing exploitation by private (as opposed to public) middlemen, and hindering unofficial exports.

The establishment of a Monopolies and Prices Commission is the fifth covenant of the FY 1983 agreement. The government has completed a study and has prepared a draft law to ensure orderly marketing practices, to secure fair prices for consumers, and possibly to help government decide which basic commodities to decontrol. (A sixth covenant deals with the ESF program evaluation.)

The preparation of strategies for parastatal divestiture is the seventh FY 1983 covenant. A task force studying the subject is investigating the legal and budgetary implications of parastatal reorganization and is to report its findings and recommendations to the Cabinet.

Technical Assistance and Policy Change

Technical assistance provided under the FY 1983 ESF Agreement has been the principal instrument for policy discussion and implementation, and has thereby kept the Structural Adjustment Program Grant alive as the basis for dialogue between the Kenyan and U.S. governments. In the absence of this \$2 million grant for studies, consultancies,

and other technical assistance, the impact of the \$28 million in foreign exchange and budgetary support would have been substantially reduced. USAID has committed approximately one half of the \$2 million since the signing of the grant agreement, and plans to commit the remainder before the end of CY 1984.

The FY 1983 agreement covered four types of technical assistance support:

1. Technical assistance pool in agriculture. In November 1984 USAID committed \$900,000 in support of the Technical Assistance Pool in the Ministry of Agriculture and Livestock. This long-standing source of advisory support has not been successful as yet in institutionalizing a policy planning capacity in the Ministry. However, consultants find that their advice is accepted on specific policy issues such as grain pricing and grain reserve levels, and in the areas of budgetary and management reform.

2. Improved analysis, budgeting and administration of development projects. The Ministry of Finance and Planning has recently submitted a \$100,000 request for technical assistance in these areas. Short term consultancies have meanwhile been provided to improve computerized reporting systems for external and internal debt (including debt of parastatals owed to Treasury).

3. Studies. In order to facilitate policy implementation, government has called on consultants to help define and draft policy options in several areas. These include effective protection, parastatal divestiture, monopolies and prices, import administration, and use of microcomputer technologies in various parts of government. In late 1983, the Central Bank requested two senior consultants to improve Central Bank management, to improve management and inspection of the commercial banking system, and to establish a system of deposit insurance in Kenya. The primary goal of these two consultancies is to improve domestic resource mobilization by improving the efficiency and safety of Kenyan financial markets.

4. Microcomputer assistance. A \$150,000 request for U.S. microcomputer assistance was stalled throughout most of 1984 by policy deliberations on the employment implications of microcomputer technologies. USAID has now received and processed a government request for microcomputer hardware, software, and technical assistance to expedite further work in the areas of donor coordination, project monitoring, budgeting and import administration.

FY 1984 Conditions and Covenants

USAID/Kenya has recently completed ESF negotiations for FY 1984. Conditions and covenants for FY 1984 reflect both the successes and failures of the FY 1983 agreements. Instructions for meeting the FY 1984 conditions and covenants have not yet been transmitted to government as Implementation Letter No. 1. The conditions and covenants for FY 1984 are attached below for further discussion, although it is not yet clear how implementation may proceed in the face of the current drought in Kenya, and collateral political resistance to change catalyzed and supported by external sources.

ECONOMIC POLICY REFORM IN INDONESIA
A BRIEF BUT ENCOURAGING NOTE

by Robert L. Rucker

Background

Indonesia is an archipelago of over 13,000 islands containing 160 million people from a immense variety of cultural backgrounds. It is a newly arrived member of the lower middle-income group of countries with current per-capita income of \$510. As a member of OPEC and a highly successful participant in the Green Revolution, it has experienced high economic growth rates averaging almost eight per cent per year during the period 1973-81.

Similar to many other countries, Indonesian economic growth fell dramatically to just over 2 per cent in 1982, largely because of the negative impact of world-wide recession on both its oil and non-oil export earnings. The situation further worsened in late 1982 and early 1983, reaching crisis proportions (in balance of payment terms) with the decision by OPEC to cut oil prices to \$29/bbl and to reduce oil production quotas. This precipitated a 27.6 per cent devaluation of the Indonesian rupiah in late March 1983 and culminated in a wide-reaching economic policy reform package that has received universal praise by outside observers.

Indonesian policy makers have been praised not because they took action but because of the type of policy actions taken and the way in which they were introduced. The policy reforms were strategic in nature and long-term in outlook despite the urgency of balance of payment pressures at that time. The reforms were almost universally corrective rather than repressive and moved toward greater reliance on market mechanisms. The reforms were mutually complementary and designed both to restore short-term stability and confidence in the economy and to move toward needed long-term adjustments. The reforms were introduced in a rapid-fire, decisive fashion that gained respect of even the most hardened critics, including the international financial community.

What then were the policy reforms that had so impressed the outside observers? Briefly, they consisted of six sets of actions: (i) highly disciplined budget austerity

achieved primarily through the reduction or elimination of food, energy, fertilizer and pesticide subsidies, and control of other current (as opposed to investment) expenditures, (ii) devaluation of the rupiah and adoption of a managed-float exchange rate policy, (iii) rephasing of \$21 billion of public sector investment with over \$10 billion of import content, (iv) fundamental reform of monetary and banking policy that abolished bank credit allocation ceilings, essentially freed bank lending and deposit rates and established traditional instruments of monetary control, (v) initiation of first steps toward deregulation of the private sector, and (vi) fundamental reform of tax legislation, including major revision of income tax laws and establishment of a new value added tax law. In sum, the government took major steps to mobilize both private and public resources and to improve their allocation while at the same time stabilizing the immediate budgetary and foreign exchange situation. Monetary, fiscal and foreign exchange policy moved in full concert during this period and factor pricing was substantially improved.

Obviously many of these policy measures were not spur of the moment reactions and had been under development or consideration for some time. The tax legislation had been under study and drafting for at least two years, for example. Similarly, the banking and financial reforms were not simply pulled out of the air. And the government had long since recognized the dangers of open-ended subsidy policies for both the budget and foreign exchange reserves, having increased energy prices 46 per cent three different times in the three preceding years.¹ In other words, the Indonesian government did not just suddenly become policy conscious in early 1983. The balance of this note will look briefly at some of the factors that lay behind this success story, including those that appear to currently circumscribe future policy reform prospects. A brief look at AID's role in Indonesian policy formulation is also included.

Major GOI Policy Actions 1983

1. Introduction of Austere 1983/84 Budget 1/83
 - current budgetary expenditure essentially held constant in nominal terms; total budget constant/falling in real terms
 - continued government wage freeze
 - 50 per cent rise in domestic petroleum and fertilizer prices

- certain food subsidies abolished
 - pesticide subsidies reduced
2. Devaluation of Rupiah 27.6% vs. U.S.\$ 3/83
 - adoption of new basket of currencies reflecting major trading partners and competitors
 - adoption of managed float policy with intent to maintain competitiveness of real effective exchange rate
 3. Rephasing of Public Sector Investment 5/83
 - estimated \$3.0 billion FX saving 1983/84
 - estimated \$7.4 billion FX saving subsequent years
 - stated intent to reallocate associated domestic project savings to new labor intensive projects
 4. Reform of Monetary/Banking Policy 6/83
 - State Banks free to set deposit and most lending rates
 - detailed rediscount mechanism simplified so as to restrict access to only the highest priority sectors
 - quantitative ceilings on individual bank's credit expansions abolished
 5. Review of Regulations Affecting Private Sector Initiative 7/83
 - Priority given by the cabinet to simplifying investment licensing, regulatory and administrative procedures
 - Program begun to overhaul and simplify export procedures; single-commodity export review teams established
 6. Reform of Tax Legislation 12/83
 - major revision and simplification of personal and corporate income tax laws
 - replacement of sales taxes with valued added tax plus luxury sales tax
 - revision and simplification of tax administration and procedures

Factors Impacting on Policy Reform

It seems important to ask why Indonesia was able and willing to put together an economic policy reform package in 1983 that would be the envy of development advisors anywhere. The answer seems to have at least four parts: (i) a strong development oriented government that listens to economists, (ii) a well trained, highly competent core of economists in key high level positions that in turn listen to good advice, (iii) the existence of high quality external

advice from a number of sources including the IBRD, IMF, long-term U.S. residents, and U.S. and European financial houses, and (iv) the room to maneuver economically both because a reasonably comfortable resource and capital base exists and because hard decisions are not put off by the government until there is no choice and adjustments become catastrophic.

Development Oriented Government - The Government of Indonesia (GOI) sees development as an integral part of stability and security. This has been the case basically since the attempted coup in 1965 and the subsequent establishment of the Soeharto New Order Government. That government came into power at a time of political and economic chaos and remembers it well. There is a general absence of significant hard-core anti-free market ideologists, although Indonesians and many within the GOI are highly inward-looking and protectionist in bias. On economic matters the GOI tends to be pragmatic and decisive once an issue is clear. The GOI appears to be relatively progressive despite its obvious desire to exercise central control.

Well Trained/Experienced Economists - An experienced, well trained, highly competent core of economists occupy almost all important economic positions, i.e. at ministerial and directorate general levels. This cadre basically came to power as a group, recruited primarily from the University of Indonesia (although many were trained abroad, particularly in the USA) and have been together for the last fifteen to twenty years. This group of economists have the confidence of the President and probably at least some of the other important elements of the power structure, including the military. Younger, well trained economists, tend to be found at second and third tier positions within the government and also at the universities. Indonesian economists and economic policy makers tend to respect good analysis and advice, and have the ability to distinguish the difference. They are willing to both solicit and listen to policy advice.

High Quality External Advice - The Government of Indonesia has encouraged strong advisory assistance from a number of quarters since the Soeharto government came into power. The IBRD and IMF have both played important policy advisory roles on a number of economic issues, particularly at the macro-economic level. What seems to be equally or more important are long-term relationships that exist between ministries and individuals within the government and several U.S. universities and individual professors.

Long-term resident policy advisors from the U.S. have also played important roles. AID, although involved with policy processes at project and sectoral levels, has not been involved in an advisory capacity at the macro-economic level.

Room for Maneuver - Indonesia is a lower middle income, resource rich but population-burdened, country. Meaningful opportunities exist, particularly if natural resource wealth is used wisely, i.e., a substantial natural resource endowment exists including large open frontiers that are relatively unpopulated or exploited. Major population pressure exists in Java where two-thirds of the country's population live on seven per cent of the land area. The government has a relatively good reputation for taking major economic policy actions before they are absolutely forced to do so or before adjustments become too disruptive, costly, or politically impossible.

The following list briefly summarizes some of the more important factors that both define the need and the prospects for next steps in the reform of the macro economic policy environment. Indonesia, despite its commendable record over the last two years, requires important rationalization and deregulation of its trade and industrial policy if it is to successfully restructure its economy toward high (non-oil led) long-term growth path. It must also press ahead with timely implementation of some of the policy decisions already taken, although this will not be dealt with here both for lack of time and also because the GOI seems to have the situation relatively in hand.

Factors Affecting Policy Reform Prospects

Positive

1. Development-oriented government.
2. Well trained economists in key decision making positions.
3. Apparent high level appreciation of good analysis and advice; willing to both solicit and listen to high quality, authoritative advice.
4. Strong natural resource base; reasonable physical infrastructure in place; finances, including both external reserves and external debt structure, in reasonably good shape.

5. Overall a good set of economic policies are in place; factor prices are generally in order; market interference is not intolerable; government is able and willing to exercise considerable economic self-discipline.
6. IBRD/IMF generally play major advisory roles; so do long-term unofficial U.S. advisors and U.S. and European financial houses. Bilateral lenders and ADB, including USA, principally have effect through project-related opportunities.
7. The Indonesian government has a record of reasonable foresight and tends to take action before its back is against the wall, although recent major reforms were put off until situation had deteriorated.

Negative

1. Population pressures and "employment problem" require rapid economic growth.
2. Long-term prospects for oil are negative or flat in real terms.
3. Need to reduce oil dependence--need to gradually replace oil as major source of growth and as source of approximately 70 per cent of both budgetary revenues and export earnings.
4. Need new, outward looking industrial-trade policies which require major import trade policy reforms and changes in industrial licensing and regulation.
5. A long history of import substitution has built up a large inventory of protected interests and industries. Powerful vested interests (political, bureaucratic, military, and economic) would be adversely affected by major reform.
6. Both pervasive (institutionalized) corruption and powerful vested interests hamper the process of development and prospects for certain types of economic policy reform.
7. The extremely successful history of major growth in rice is probably about to level off. Continued rapid agricultural growth requires diversification. Rural areas are home to 77 per cent of population, two-thirds employed in agriculture.

AID's Role in Indonesian Policy Formation

AID has relatively small program in Indonesia relative to either total donor development assistance (less than five per cent) or to the development portion of the GOI budget (approximately one per cent). AID attempts to compensate for the lack of size to its program by focusing on its quality. Innovation and experimentation that may subsequently be replicated lie at the heart of present project design philosophy. The ability to influence policy for the better is implicit in this approach. AID does not limit but will tend to focus its policy efforts in the four program areas identified in the CDSS: i) food production; ii) off-farm employment; iii) primary health care and family planning; and iv) human resources development.

"Strengthening policy analysis and formulation in selected problem areas is integral to the Mission's (CDSS) strategy. More specifically, the Mission's objectives are to: 1) expand and improve information relevant to development policy issues noted in the CDSS, and 2) provide support to strengthen capacity for analysis and planning in Indonesian institutions concerned with these issues.

Increased attention to policy analysis at this juncture in Indonesia's development is particularly timely. The sharp downturn in the economy has encouraged an openness to policy alternatives which has already resulted in a number of important policy decisions, as noted. Receptivity to policy analysis and debate was also heightened by the appointment of a new Cabinet in April 1983, which was given the mandate by President Soeharto to find ways to promote development, increase efficiency, and mobilize resources at a time of declining government revenues.

Although macro-economic policy issues are not excluded from the Mission's area of concern, these issues are generally well addressed by government with help from the IMF, the World Bank, European and U.S financial houses, and long-time resident U.S. advisers. Therefore, the Mission's focus rests more on middle-level sectoral policy questions, primarily in the substantive areas in which the Mission has staff competence, experience, contacts and a program interest."²

Although the above excerpt summarizes a reasonable outlook for AID involvement in macro level economic policy reform, we remain highly sensitive to the key restructuring issues facing the Indonesian economy. The Mission stands ready, I believe, to promote or provide appropriate policy advisory assistance as the opportunity may arise. Despite the apparent intractability of many of the reform questions that lie ahead, the economic policy reform climate in Indonesia has many strong positive elements and, therefore, grounds for guarded optimism.

Indonesia
IGGI DONOR CONTRIBUTIONS
FY 83/84 - 84/85
(Millions US\$)

<u>Bilateral Donors</u>	<u>FY 83/84</u>	<u>FY 84/85</u>
Australia	40.7	39.8
Belgium	6.9	6.4
Canada	32.4	30.7
France	51.0	51.2
Italy	-	30.0
Japan	279.3	321.3
Netherlands	56.1	53.2
Switzerland	-	4.1
United States	106.5	115.0
West Germany	-	37.4
U.K.	-	5.9
Total Bilateral	<u>572.9</u>	<u>695.0</u>
 <u>Multilateral Donors</u>		
Asian Development Bank	400.0	500.0
EEC	16.0	14.0
UNDP	39.0	38.0
UNICEF	12.5	12.4
World Bank	1,200.0	1,200.0
Total Multilateral	<u>1,667.5</u>	<u>1,764.4</u>
Total Donor Contributions	<u>2,240.4</u>	<u>2,459.4</u>

Footnotes

¹ At this writing energy prices have been increased forty-sixty per cent five different times in five years.

² Excerpt from Country Development Strategy Statement FY 1986: Indonesia.

POLICY DIALOGUE IN THE DESIGN OF AID SECTOR ASSISTANCE: THE CASE OF NIGER

by Kiert Toh

Introduction

Like many AID assistance programs in Sub-Sahara Africa, the AID program in Niger is concentrated in the agriculture sector. Until 1982, the program placed little emphasis on economic policy and policy reform. Following the publication of the 1981 IBRD report on Africa (Accelerated Development in Sub-Saharan Africa: An Agenda for Action)--known widely in the development business as the Berg Report--and the adoption of policy dialogue as one of AID's priority areas in addressing development problems, the AID program in Niger shifted emphasis toward economic policy and policy reform, particularly in agriculture. The process began in 1982, coincidental with Niger's deteriorating economic situation, characterized by large financial imbalances internally and externally, unsustainable debt obligations, and poor economic performance of state-owned enterprises, several of which are related to agricultural activities. The policy dialogue initiative culminated in the signing of a sector assistance grant agreement (Agricultural Sector Development Grant [ASDG]) in August 1984 by the Nigerien authorities.¹ Under the grant, the Nigerien government agreed to implement an agricultural policy reform program and to continue policy discussions with AID.

This paper provides an analytical description of the policy dialogue process involved in designing the ASDG program. It is intended for sharing the experience with other AID missions and for generating appraisal of the design process for future sector assistance efforts in matters related to economic policy and policy reform. The next section provides a summary of the Niger ASDG policy reform program. It is followed by a description of the policy dialogue process, the conditionality, and the criticism of policy reform as a prerequisite for economic growth and development. An attempt is also made to identify the obstacles encountered in the process and the factors contributing to the convergence of policy thinking and mutually agreed reform measures.

Niger Agriculture Sector Development Grant

The Niger sector assistance program focuses on the policy dimension as a prerequisite for structural adjustment and growth in the agriculture sector. The resources from the grant are targeted for supporting reform measures, recurrent and local costs of agricultural development activities, and technical assistance in policy analysis, policy formulation, and implementation. The amount of the grant is \$32 million over a four-year period. It will be made available to the Nigerien government in four tranches subject to satisfactory performance in the agreed reform measures.

The general theme underlying the reform program is deregulation and promotion of workable competition through more private sector (including cooperatives) participation in the areas of agricultural product pricing and marketing, agricultural input pricing and distribution, trade with neighboring countries--especially Nigeria, and reformulation of agricultural credit policy and management.

The policy instruments for achieving the objectives include changing government practices in price setting, budgetary allocation and discipline, and removing various administrative controls in marketing and distribution of agricultural products and inputs. These changes are aimed at removing distortions of market signals and providing market incentives which are necessary for the development of the private sector.

A number of policy instruments chosen are simple but require persuasion to minimize resistance from officials responsible for implementing the reform. Some policy instruments involve changing government decrees, rules and regulations. Examples include: removing prohibition on private traders to buy and sell grain freely or to distribute agricultural inputs; reducing restrictions on the free movement of grain across different provinces or districts in the country; and changing government practices in input price setting, subsidies, and controls of border trade. Other policy instruments involve structural changes and require external assistance in carrying out the reform. Examples of these include: setting up the system of tenders and bids to replace the current price setting of the grain marketing board; dissemination of price and marketing information to promote competition; and privatization of the state-owned agricultural input supply system.

The Policy Dialogue Process

This section discusses the policy dialogue process during the design of Niger's policy-oriented sector assistance. It is intended to illustrate the essential factors for a useful policy dialogue and to identify possible obstacles involved in the process. The major relevant factors are: the role of government in a mixed economy; the second best problem; knowledge of country specific situations; and the question of conditionality. An attempt is also made to highlight the linkages between the economic analytical underpinnings of the program, their assumptions, and the proposed reform measures.

I. The Role of Government in a Mixed Economy

Underlying the whole policy dialogue is a broader question of the role of the government in an economy like Niger. In general, AID views market-oriented solutions to economic development problems as relatively more efficient than solutions imposed by the government. And the private sector is a useful vehicle as well as a source for additional resources and energy. Historically, Niger has generally viewed market-oriented solutions with skepticism and is particularly distrustful of the private sector. Consequently, government controls and interventions in the economy are pervasive. The general principle underlying the policy approach adopted by the government is what might be termed the market failures approach. According to this view, extensive government interventions and controls are necessary to correct the failings of unregulated markets. Critics of the market-oriented approach argue that markets in Niger are dominated by monopolistic power, immobility of labor, inadequate information, and infrastructure. These imperfections make it not possible for the economy to achieve optimality through market solutions. The private sector is not ready to take over the marketing and distribution functions now performed by the state.

The private sector issue was further compounded by the commodity import program initially proposed as a local currency generating mechanism for the grant. The mechanism has been viewed skeptically by the Nigeriens and was interpreted as a means for subsidizing the United States private sector. This thorny issue was finally resolved by AID abandoning the use of the commodity import program as a modality for local currency generation.

II. The Theory of Second Best

While the concerns raised about market imperfections and the private sector potential are legitimate, the adoption of the market failures approach as justification for extensive government regulations ignores two important factors: the problems of second best and of government failures.

The theory of second best is concerned with a situation in which one or more of the efficiency conditions cannot be met.² It asks whether, under these circumstances, it is still desirable to fulfill the other conditions which can be met. For example, suppose there exist a monopolist and a monopsonist in the economy. This violates the optimality conditions. Suppose through government action, the monopolist is forced to fulfill the efficiency criteria, but not the monopsonist. The theory asks: Can one be sure that this will increase the country's well-being? The answer is: there is no assurance that the reduction in the number of unfulfilled conditions (in the example, from both monopolist and monopsonist to only monopsonist) will result in increased social welfare, because some of the conditions remain unsatisfied (i.e., the existence of a monopsonist).³ In this particular example, the distortion associated with a monopsonist may be reduced by the presence of a monopolist.

The theory of second best has important implications for practical economic policy-making. The reason is that in the real world there are obviously many constraints preventing the satisfaction of all the efficiency conditions. The second best problem is always present. Although theoretically a second best solution can be identified, in practice it is very difficult to trace the complicated effects of one change in the rest of the economy and information is difficult to obtain, especially in a developing economy like Niger.

Three practical implications follow. First, it is unwise to advocate any particular policy without understanding the particular circumstances under which the policy operates. Second, the argument for government controls to correct the failings of unregulated markets is generally not valid. Government is not omnipotent. It is not only markets which fail, but there are government failures too. As described below and in various studies and evaluations cited therein, Nigerien government policies in agricultural product pricing, marketing, agricultural input distribution and subsidies, and agricultural credit have

resulted in substantial costs relative to benefits, market distortions, and preemption of the private sector and cooperative participation. Third, given the fact that market failures are relative and not absolute and the continuing presence of the second best problem, one practical solution is to compare the relative efficiency between public and private sectors and allow each to do those things which it can produce better than the other. Given the pervasiveness of government intervention in Niger's economy and its failures, it is only reasonable that an attempt be made to explore the possibilities and potentials of the private sector (including cooperatives).

In the policy dialogue process with the Nigerien authorities during the ASDG design, the above reasoning was maintained and reflected in the reform proposals. The reform measures for the most part involve only marginal and gradual changes in the division of labor between the public and the private sectors and in the development of workable competition in the economy. They are aimed at opening up the opportunity for indigenous private agents to have a larger economic role and to allow Niger's economy to uncover additional options which would lead to a more efficient use of public sector resources and a higher level of income as the country goes through the development process. This is illustrated by three specific reform proposals in the ASDG: restructuring of agricultural input distribution and subsidy policy; role of the grain marketing board in price stabilization and management of grain reserves; and agricultural credit policy and management.

The proposed restructuring of the agricultural input distribution toward an increasing dominance by cooperatives and the private sector will be gradual. As currently envisioned, it will take a minimum of five years to liquidate the official input supply agency. The effort is also being complemented by another AID project (Niger Agricultural Production Support Project). While one of the objectives of the subsidy reduction policy is to help improve the responsiveness of input suppliers to the needs of farmers, it is also balanced by the need to reduce risk to farmers of adopting uncertain input packages and the lack of agricultural credit. This explains why the targeted subsidy reduction is in terms of the average level, leaving decisions on subsidy reductions of individual inputs to the Nigerien authorities following an assessment of each input's contribution to increased productivity and the reliability of supply sources especially from Nigeria.

In the reform measure concerning the role of the grain

marketing board in price stabilization and management of grain reserves, the emphasis is placed on shifting some of the functions currently performed by the marketing board to cooperatives and private traders and the promotion of workable competition. While the policy direction for agricultural credit is to move more toward using the informal credit market and the mobilization of private savings for the source of funds, information about this market is, however, too scant to allow concrete policy formulation. As a result, an indepth analysis of the situation is planned under the ASDG.

III. Knowledge of Country Specific Situation and Importance of Sound Economic Analysis

The design of the ASDG is based on a number of analyses and information gathered from different ongoing projects as well as knowledgeable Nigerien officials. Of major significance to its design are the following AID-financed studies: Niger Agricultural Sector Assessment (1979); Joint Program Assessment of Grain Marketing in Niger (1983); An evaluation of the Agricultural Technical Packages for the Republic of Niger (1983); The Market for Livestock from the Central Niger Zone (1982). Other major relevant analyses and studies financed by other donors include: the French (Caisse Centrale) and European Development Fund study on the Niger Agricultural Credit Institution and its problems (1984); the IBRD and the Canadian studies on the Niger Grain Marketing Board (1984); the IBRD Agricultural Sector Memorandum (1981); and the Niger recurrent cost study (1983). These studies together with evaluation reports from a number of rural development and livestock projects provide the necessary knowledge for the design of the ASDG policy reform program.

Knowing and understanding the specific country situation are fundamental to a productive policy dialogue. While there are several instances which indicate the importance of this during the ASDG design, it is clearly illustrated by the input subsidy and the pricing and marketing issues. These policy questions require country specific knowledge and understanding of their policy objectives. The dialogue is not simply a matter of persuading the authorities to reduce the levels of subsidies or to increase official grain prices.

Agricultural Input Subsidy Policy

The objective of agricultural input subsidies is to promote the adoption of modern input packages. Economic

rationality would dictate that more subsidies should be given to inputs for which potential economic returns and viability are high (in the absence of subsidies), but which farmers are reluctant to use because of the risks involved or incomplete information about their benefits. Inputs, the benefits of which farmers are already convinced, should receive fewer subsidies or no subsidies at all. Furthermore, one would want to be able to distribute inputs to as many farmers as possible. The distinction that should be borne in mind here is between subsidies for promotion of adoption of modern inputs and subsidies as transfers to needy farmers. In the case of Niger, the objective is the former. This distinction has important implications in the reform proposal.

Theoretically, subsidies for the promotion of technical input packages as well as for correcting certain market imperfections could be justified on economic grounds. In reality, evidence from the studies mentioned above indicates that the input supply system and its associated input subsidy policy have not worked out as anticipated and policies have not been based on sound economic analysis. Fewer inputs are available to farmers, many of them were not delivered to farmers on a timely basis, rates of subsidies on a number of inputs--especially agricultural equipment and animal carts--cannot be justified economically. Moreover, a relatively large amount went to subsidize inefficient operations of state-owned agricultural input supply enterprises.

In addition to the implementation problems mentioned above, there is some doubt as to the existence of an economically viable technical package for rainfed agriculture to justify the wide range of subsidies given to the inputs (see, for example, AID-financed study: An Evaluation of the Agricultural Technical Packages for the Republic of Niger). This does not preclude completely the use of subsidies. It does, however, mean that the so-called technical package has to be unbundled and subsidies be applied selectively to individual inputs based on each input's economic contributions. The rate of subsidies for each input should be adjusted and subject to the budget constraint with the objective of making the inputs available to as many farmers as possible. Moreover, subsidies should be channeled to the farm level instead of being used to subsidize inefficient parastatal operations, and be phased out once the inputs have been adopted by a certain number of farmers. These are essentially the rationale underlying the case made for changing the current practice. AID and the Nigerien government are in complete agreement with the

policy objective. The authorities, after being presented with the evidence and the argument, agreed to implement the proposed reform measures.

Grain Marketing and Pricing Policies

In addition to managing the grain security reserve, the objectives of the grain marketing board's price and marketing policies are price stabilization and the control of grain movement to protect consumers as well as farmers from being exploited by private traders. Evidence from a number of studies indicates that in practice the marketing board has not been able to stabilize grain prices and the exploitation question can be better dealt with by other means than direct restrictions of grain movement (such as increased competition between the marketing board and private traders in areas where potential exploitation exists). The marketing board's practices have resulted in large losses because it was not able to predict and set prices to reflect market conditions.

At the time of the ASDG design, the marketing board had an excessively large reserve to maintain. Consequently, it incurred a large debt; its financial burden on the government budget has been the target of reform by donors like the IMF and the IBRD. In view of the political sensitivity of the issue and the fact that AID is a bilateral donor, the policy discussion was limited to finding alternatives to achieve price stabilization and provide adequate price incentives to farmers taking into account the financial implications of the marketing board operations and its ability to function effectively. The stock issue was essentially side stepped because of the political nature of the Niger marketing board.

The policy dialogue basically focused on promoting workable competition in grain marketing, eliminating the role of price setter from the marketing board's functions, increasing the use of cooperatives as marketing board agents in grain storage to be done at the village level. The policy instruments include: issuing administrative decrees to remove all restrictions and fiscal impediments, except requirements for professional licensing, on the movement of grain within the country; broadcasting grain marketing information by the marketing board; increasing use of cooperatives for grain storage at the village level; eliminating uniform national pricing; establishing the use of a system of tenders and bids for the marketing board's buying and selling of grain; and reducing the role of the marketing board, particularly in urban markets, toward that

of managing food reserve stock at the wholesale level, food aid handler, and supplier of grain to collective consumers.

The role of the marketing board in general and the use of the tender system in particular generated a lot of discussion. The tender system proposal is controversial in three respects. First it is a radical change; in effect it eliminates the marketing board's role as price setter and limits it to setting only the quantity of grain it wants to buy or sell. The price stabilization objective is to be achieved indirectly through affecting the quantity of supply which the marketing board can influence in certain markets at certain times. It is different from most other proposals up to now which generally accept the premise that the marketing board has to play the role of price setter. From that premise, most proposals encourage the marketing board to adopt a more rational pricing policy--i.e., a policy which reflects existing market situations. the ASDG proposal abandons that premise. It argues that the marketing board is not in a better position than the market to dictate what the price should be. The price stabilization objective, if it is necessary, can also be achieved through intervention on the quantity side.

Second, the tender system proposal requires that the concept of minimum or floor price be abandoned to generate useful price signals which reflect market conditions. This is difficult for Nigerien officials to accept because floor prices are viewed as necessary production incentives to farmers. The U.S. model of agricultural support is frequently invoked to support their argument. In response to their concern, it was pointed out that a floor price can be effectively maintained only if the marketing board has the financial resources to purchase all the excess supply below the floor price. Otherwise, its benefits will go to those who are lucky enough to sell to the marketing board before its resources are exhausted. A two-tier price system will develop, one used by the marketing board and one in the parallel market. It is doubtful that this will really benefit farmers--particularly, after having brought all the grain from the villages to the marketing board's buying centers, only to find that the board could not buy any more. Farmers are then forced to sell their grain at whatever prices they can fetch in order not to have to transport it back. This was the situation in 1983.

Furthermore, for the floor price to have real incentive effects on production, it has to be set before the planting season begins. It has proven to be almost impossible for the marketing board to set appropriate floor prices; this

has resulted in a wide range of fluctuations in the marketing board's reserve stocks and a heavy financial burden on the government. The problem is partly attributed to the large open frontiers which generate a substantial amount of cross-border trade and make it difficult to predict the supply response from the marketing board's price setting.

Third, in order for the tender system to operate properly, the private sector must be able to respond to the opportunities. While Niger has experience in the tender system, most observers identify a number of problems associated with its operation, ranging from proper procedures to limited responses from the private sector to unfulfillment of contractual obligations. This concern is shared by both the Nigerien authorities and AID. It is recognition of the institutional capacity and the private sector past performance in this area that persuade an experimental approach for this proposal.

IV. Conditionality in the Sector Assistance Program

Since a substantial portion of the ASDG is intended for financing of recurrent expenditures of ongoing projects and rehabilitation programs in the sector in return for a sectoral policy reform program, agreement on clear policy objectives, scheduled targets, and implementation plans is necessary. Conditionality is an unavoidable part of a program of this nature to ensure the integrity of the program and to make possible for the donor government to answer responsibly to its own constituents at home. The accountability question is a necessary constraint--whether it is provided by multilateral or bilateral donors. However, for a bilateral donor program like AID sector assistance, the existence of foreign policy objectives imposes an additional constraint. There are always losers in any policy reform program; consequently, politics (both from the donor government as well as host country government perspectives) cannot be ignored.

An important component of foreign policy objectives is economic stabilization. Economic stability is a prerequisite for political stability. It is no exception in the case of Niger. Economic stabilization assistance for foreign policy objectives, however, tends to impose less strict or no conditionality at all.⁴ The conflicting objectives arise when economic stabilization is accompanied by promotion of policy reform to bring about necessary economic adjustments. In this context of a political economy, two important questions arise: First, how strict

and rigid should the conditionality be? Second, when is the appropriate time for policy reform oriented sector assistance?

For the most part, as the dialogue advanced, there was agreement in the policy direction, its objectives, and the instruments for attaining them. The introduction of conditionality, however, raised a lot of discussion and negotiation. It was probably the most controversial aspect of the ASDG. It centered around two issues: the selection of performance criteria to be used as conditions and the degree of flexibility in the chosen conditions.⁵

The performance criteria in the ASDG have been criticized as being "not strict enough" as well as "too strict". Advocates of strict conditions argue for more specific criteria with quantitative targets and an explicit schedule to meet the targets. Others argue that it will be difficult for the Nigerian government to meet the targets laid out in the ASDG. This would result in AID having to stop the disbursements of the grant and the policy dialogue as well as the economic stabilization objective. Both are probably correct in some aspects of the program. But this is to be expected when trade-off and compromise have to be made; and selectivity of reform measures is important for productive dialogue and negotiation.

This explains why some of the issues have not been addressed in the ASDG: for example, the size of the marketing board's reserve stock, the broader question of price controls including consumer prices in the economy, and the agricultural credit institution. Aside from these issues, the ASDG incorporates a set of conditions, both quantitative and qualitative, which is acceptable to the Nigerian authorities.

The formulation of quantitative conditions in policy-oriented sector assistance program is more difficult than macro-economically oriented quantitative conditions for economic and financial stability (such as credit ceilings and overall government spending), for several reasons. First, the stabilization theory at the macro level is more developed and there is more evidence in support of the relationship between stabilization and the variables chosen as performance criteria; hence, more confidence can be placed on conditions. On the other hand, the association between the policy factor and the eventual goal of agricultural growth and development is fragile. It can easily be upset by external shocks or factors which are difficult to predict, such as the closure of the Nigerian

frontiers and the drought in the case of Niger. Both of these are likely to impede or delay achievement of the policy objectives. Second, the contribution of appropriate policies to economic growth is indirect. Getting the policy right is only the necessary condition; external resources for technological transfer and institutional development are also required. The two reasons mentioned here suggest that flexibility would be required to deal with policy reform at the sectoral level. Conditionality must be viewed in relative terms; interpretation of whether certain conditions are met has to be reviewed in the context of specific circumstances and decisions based on informed judgment.

The timing for the negotiation of policy reform also played a very important role. AID's policy reform initiative in Niger coincided with the country's budgetary, balance of payments, and debt servicing difficulties. The need for economic stabilization was evident. It is the most important factor in persuading the Nigerien authorities to seek fast disbursing assistance from the IMF to meet its immediate crisis. At the same time, studies financed by different donors, notably AID and the IBRD, began to convince the government of the urgent need for policy and institutional reforms to address more effectively the country's structural and longer term problems. Two policy-oriented conferences (the Recurrent Cost Workshop and the Conference on Agricultural and Rural Development--known as the Zinder Conference), financed by AID were held and attended by resident donors; and in the case of the Recurrent Cost Workshop, it also included the IMF, CILSS and CLUB DU SAHEL. The conferences contributed to increasing awareness of recurrent cost implications of public investment and setting the policy direction related to agricultural and rural development. These conferences together with the adoption of austerity measures under the IMF program, provided a positive environment for productive policy dialogue. They complemented and helped the design of the ASDG.

V. Critics of Policy Reform

In his observation of the contribution of the IBRD Accelerated Development in Sub-Saharan Africa: An Agenda for Action, Professor Berg commented that the most useful result of the report has been the discussion it has generated over broad issues of development strategy. In his words: "Economic policy has won a place at the high intellectual table, and policy reform will be a major prerequisite of renewed growth in the decades ahead."⁶

Not everyone agrees with the statement. In the case of the ASDG, criticisms of policy reform as a prerequisite for economic growth center around two arguments: the sovereignty question and the lack of visibility from money spent on "buying" policy reform.

It is often argued that it is not appropriate for bilateral donors like AID to ask an aid recipient country to undertake reform measures because this will be an infringement on the country's sovereignty; will smack of colonialism; and will pose an obstacle to United States foreign policy objectives. Underlying this criticism is the conditionality issue. Unlike project aid where disbursements of funds are tied to certain activities which are easier to identify, sector assistance is tied to policy reforms; disbursements of funds are conditional on the satisfactory undertaking of the agreed reform measures. This is necessary for AID to maintain some leverage in the discussion of the program implementation. With regard to the sovereignty question, the recipient country always has the option of refusing the assistance. If conditionality is perceived to impinge on the country's sovereignty, policy-oriented sector assistance should not be contemplated.

Unlike building roads or bridges, it is difficult to see the direct association between resources expended on policy reform and immediate visible outcome. On the other hand, it is well known that there are visible prestigious government buildings, conference rooms, a sports stadium, and over-sized factories which contribute little to the country's sustainable economic growth and the income of the majority of the population. Prevalent in many Sub-Saharan Africa countries are under-utilized factories, abandoned irrigation perimeters, unmaintained roads, schools lacking books and other materials, and hospitals without adequate medical supplies. This is typical following withdrawal of donors' financial support, usually resulting from insufficient consideration of the policy dimension (such as, policies related to recurrent costs and incentive system) in the development strategy and political expedience.

Conclusion

What conclusions can one draw from the Niger ASDG design experience? More specifically, what are the factors which contribute to the successful negotiation of the ASDG? What are the obstacles in the negotiation process and in what lies ahead and the consequent implications for policy

dialogue during the implementation phase? What lessons has one learned which may be useful for future AID policy-oriented sector or nonproject assistance?

Three major factors contribute to the successful policy dialogue process in the design of the ASDG: first, the country's worsening economic and financial situation; second, knowing and understanding the country-specific situation and sound economic analysis; third, selectivity and flexibility. The first factor forced the Nigerien authorities to rethink their policies to improve the allocation of declining public sector resources. The IMF program, by imposing austerity measures, helped in this respect; it also encouraged the authorities to engage in policy discussion with other donors and to seek additional assistance from them. However, the agreement on the ASDG proposed reform program would not have been possible if analyses and studies were not undertaken in advance. The studies cited in Section III.C of this paper and the numerous formal and informal discussions which were part of these studies had helped improve common understanding of the problems and the policy objectives.⁸ AID's willingness to be selective, flexible and sensitive to political considerations of certain reform measures facilitated the conclusion of the negotiation and a fruitful policy dialogue process.

The obstacles encountered during the ASDG design include: resistance by some Nigerien officials to the use of conditionality; incapacity to absorb the full implications of some of the reform measures; and inability of the Ministries of Rural Development and Planning to coordinate policy discussions with other ministries and governmental agencies, which are responsible for implementing the policy changes. The last two points are best illustrated by the implications of the proposed tender system mentioned in Section III above. Although they were discussed in the policy dialogue, it is doubtful that all the Nigerien officials involved understood the implications of the proposed reform. This is due partly to poor communication and coordination among Ministries of Rural Development, Planning and the grain marketing board and partly because the marketing board resisted the policy changes.

Policy dialogue is an ongoing process and policy modifications are part of the process. They are inevitable and they become even more important as reform measures are implemented and possible side effects or unanticipated outcomes emerge. They are to be expected because policies

are usually made under conditions of uncertainty. This is partly due to the information problem and partly because of the early stage of the country development which makes it more difficult to predict responses from policy changes with a high degree of accuracy. This means that policy reform programs must incorporate some degree of flexibility to allow faulty recommendations to be corrected following the policy implementation.

But for the host country government as well as donors to recognize they need to reformulate policies in light of new evidence, there must exist capacity to collect and absorb policy relevant information and knowledge as well as ability to analyze and reformulate alternative policy options. Recognizing policy dialogue as a learning and transfer of knowledge process suggests that the merit of a policy oriented program like the Niger ASDG ought to be seen in its contributions to the host country's increased awareness of policy factors and the development of policy analytic capacity in addition to its impact on agricultural production and economic stabilization. This is important because it is easy not to address the policy question by pointing out the negative or unanticipated effects associated with policy changes considered unpredictable when policies are formulated. In the case of Niger, such a tendency is tempting because of the recurring droughts or the closure of the Nigerien frontiers. The appropriate question to ask, however, is whether the existence of these exogenous factors is sufficient, a priori, to warrant the exclusion of policy reform as an important element in the longer-term and less crisis oriented development strategy.

The experience of the ASDG design suggests two implications for consideration of future sector or nonproject assistance targeted for improved policies. First, some flexibility should be incorporated in the formulation of conditionality. Because of the uncertain outcomes of the effects of policy changes, formulating policy targets and conditionality over a multi-year period for multi-year sector assistance programs may not be appropriate. There are two possible solutions: either sector assistance programs be authorized for one year at a time; or conditions be formulated prior to the authorization of each tranche in a multi-year sector assistance program following an appraisal of performance under previous conditionalities. The latter is preferable because it makes possible the use of sector assistance for medium-term adjustment and at the same time it allows the formulation of conditionality to take into account the most

recent performance and circumstances.

Second, the emphasis of economic policy and policy reform in the AID assistance program increases the importance of having AID's own economists in the field missions. It is not realistic to expect short-term consultants alone to fulfill the necessary policy analysis and recommendations without the mission's informed guidance which inhouse resident economists are in a better position to give. AID economists in the field could actively participate in the analysis and design of policy reform program as well as serve as institutional memory and the point of continuity. But for economists to be effective in this type of situation, they have to be aware of political realities. If politics is the art of the possible, economists as design officers and policy advisors have to be artists of compromise instead of scientists of the dismal science. They must be conscious of what is possible and what is not. A consequence of this is that it is often easier to achieve small policy improvements than to effect major policy changes. This is not to say that they should follow the route of political expediency and never make radical proposals.

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Footnotes

¹ The process was initiated under the leadership of Mission Director Irving Rosenthal and continued with strong support and brought to fruitfulness with the signing of the grant agreement under the leadership of Mission Director Peter Benedict.

² In the economic jargon, the efficiency conditions are known as the Pareto optimality criteria. Pareto optimality is defined as a situation in which no one can be made better off without making someone else worse off. Market imperfections violate the assumptions from which Pareto optimality is derived.

³ For the formal proof of the Second Best Theorem, see R. Lipsey and K. Lancaster, "The General Theory of Second Best," Review of Economic Studies, 1956-1957.

⁴ In the extreme case, it amounts to writing a check to the host country government, usually in the name of budgetary and balance of payments support, with no strings attached in the area of economic performance.

⁵ Because of the use of conditionality, it also generated comments from some Nigerien officials that the ASDG looks like an IMF program.

⁶ The Georgetown University Center for Strategic and International Studies, "Africa Notes," August 5, 1984.

⁷ Paradoxically, this argument was mostly advanced by non-Nigeriens. A resident expatriate advisor at the Ministry of Planning once told the author, regarding the reforms and the conditions proposed in the ASDG, that the United States is supposed to be Niger's friend, not like the IMF.

⁸ The importance of having common understanding of the problem is illustrated, for example, by the meaning of the word "liberalization." During the discussion of trade liberalization (border and internal trade), it was learned that to Nigerien officials trade liberalization means simply less than full prohibition from participating in trading activities. The fact that they have to go through administrative and fiscal procedures does not mean trade is not liberalized. The ASDG design team, on the other hand, interpreted liberalization to mean fewer or no administrative and fiscal impediments except for simple

business licensing and registration. The different interpretation of the idea of liberalization puzzled the Nigerian officials as to why reform was needed.

SECTION FOUR:

ECONOMIC ANALYSIS OF PROJECTS

Duncan Miller

Jonathan Sleeper

Paul D. Morris

Lee Ann Ross

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DOING PROJECT LEVEL ECONOMIC ANALYSIS IN THE WEST AND CENTRAL AFRICAN REGION

by Duncan R. Miller

Introduction

The perspective of my comments is clearly that of a REDSO/WCA Officer, a traveling economist who applies his/her talents to a wide variety of "project" level concerns: identification, design, implementation, evaluation/redesign. REDSO/WCA economists, including agricultural economists, do a limited amount of strategy (CDSS), country macroeconomic monitoring and nonproject design in Ghana and Class B posts but, for the most part, we remain project oriented. This is consistent with the AID/W call for papers for this panel.

Generalizations are hard to make about the West and Central Africa (WCA) Region. Once made, they are even harder to defend. Some crude data about the USAID programs in WCA may be useful background. The 19 active DA programs in the WCA region account for less than one-quarter of the AFR Bureau's budget (FY 83 actual from FY 86 \$). Country programs range from \$1.0 million (Central Africa Republic, Congo, Equatorial Guinea and Sierra Leone) to over \$120 million with ESF (Liberia). The distribution of country programs size is given in Table 1. The shift of resources to bigger missions will leave the region even farther dispersed in terms of aggregate sizes.

As called for by the Africa Bureau strategic plan, the WCA portfolio for DA is predominantly in agriculture, rural development and nutrition (ARDN). Even within this functional account, projects run the gamut from large multi-million dollar, multi-donor institution building or infrastructure to long-run agricultural research to short-term advisory services. For example, in Cameroon the portfolio includes a six-year, \$43 million agricultural education project, a 15-year national cereals research and extension grant (\$7.6 million) and a one-year project for nutritional advisory services costing \$183 thousand. In

The author is Assistant Director for Program Analysis and Development and Senior Economic Advisor, Regional Economic Development Services Office/West and Central Africa (REDSO/WCA), Abidjan, Ivory Coast.

other WCA countries, there are ARDN projects in resettlement (Mali), umbrella reconstruction and settlement (Chad), broad area development (Niger), and animal traction (Togo). Project dispersion occurs in the other functional accounts. In addition, actual developmental activities in the region include a host of Sahel accounts, (AFR/RA, S&T, CIP, ESF and PL 480 monetized projects.) A real mixed bag.

Two final indicators, life of project (LOP) and project size should describe sufficiently the types of projects being designed and implemented in the region. As the following data on four countries picked at random indicate, most WCA development assistance projects are small scale (less than \$5 million) and short-term (less than five years LOP). Although not revealed by the project titles, a large proportion of projects in the WCA region comprise technical assistance projects; many of which have several subprojects.

LOP AND PROJECT SIZE (YEARS AND \$MILLIONS)

<u>Country</u>	<u>No. Active Projects</u>	<u>< 5 yrs.</u>	<u>< 5 yrs.</u>	<u>>5 yrs.</u>	<u>> 5 yrs.</u>
		<u>< 5m \$</u>	<u>> 5m \$</u>	<u><5m \$</u>	<u>5m \$</u>
Sierra Leone	3	2	-		1
Togo	6	5	1	-	-
Liberia	16	10	4	1	2
Senegal	29	19	5	3	1

The undeclared conventional wisdom is that such modest projects do not warrant "sophisticated" (academic or, worse, esoteric) economic analysis. Indeed, as will be argued later, much of the economic analysis sections of PIDs and PPs are really economic justifications or rationalizations of preconceived activities. As a broad generalization economic analyses are part and parcel of AID's project approval process rather than a central criterion/step of project identification, selection and design. Most economic analyses are written after the project technical aspects (inputs, outputs) are developed.

COUNTRY PROGRAM SIZE

FY 1983 - 1990

SIZE (\$ Millions)

	≤ 1	1-5	5-15	15-25	> 25
FY 83					
No. of Countries	5	6	3	3	1
% Total DA	2.2	10.2	19.4	38.8	29.4
FY 90					
No. of Countries	3	7	2	3	3
% Total DA Planned	1.2	9.7	8.9	25.5	54.7

Source: FY 86 ABS data from AFR/DP

Doing Economic Analyses

I. Project Design

Every project that REDSO/WCA scrutinizes under the Delegation of Authority 140 must contain an economic analysis. These analyses often do not follow the guidance established in Handbook 3 - Project Assistance. There are three major recurrent weaknesses which are especially noteworthy for this conference.

- lack of distinction between economic and financial analysis,
- failure to explore alternative designs, and
- weak micro-macro linkages.

There is a strong tendency for economic analyses to "defend" a project concept. Perhaps this is due to the paucity of reliable data, acute needs, or simply a desire to get things moving along. Perhaps it is due--more operationally--to the tight schedule of design teams, small project size, or design-by-contractor projects such as

in the case of Activity Justification Papers (AJPs) within an umbrella PVO project. Whatever the mix of causes, most analyses only report the hypothetical stream of nominal project benefits in relationship to the estimated stream of nominal project costs. If viable, the project is pressured to pass the "economic" analysis test. Opportunity costs of labor, foreign exchange and capital and net impact of taxes and subsidies are rarely explored; the implications are not usually investigated.

Few project design documents indicate that one or more alternative designs were explored in any depth. This is even the case where cost effectiveness or least cost rationales are employed. Many of the PP economic analyses only meet the standards of PID requirements, e.g., "describe the major categories of costs and benefits and, to the extent practicable, discuss the general economic merit of the concept proposed" (Handbook 3, Chapter 2D - 3b). Although the PID guidance specifically states that economic analyses are not always possible or appropriate, field officers "know" that an AID/W review committee would never approve a PID without one. Hence, too often economic analyses at the PP stage become rapid updates of some cursory economic rationalization at the PID level.

Apart from some descriptive goal-purpose relationships, few projects demonstrate project (usually micro) to macro economic or intersectoral linkages. Average project size and paucity of data preclude elaborate quantitative assessment (input-output matrix). The usual analysis addresses inputs to outputs and outputs to beneficiary production employment and/or income. Upstream and downstream relationships to demand/consumption/nutrition, internal trade exports and imports (or import substitution) is usually not well analyzed. In addition, sensitivity analysis, either descriptive or quantitative, of exogenous factors (tax, price, subsidy policies) is usually absent. Except for large river basin projects, project and economic analyses do not look beyond administrative/national boundaries. Projects in the Sahel, for example, should pay more attention to the dynamics of linkages (trade and migration) of the coastal countries to the land-locked countries. This has been well documented in the case of fertilizer and grain trade between Nigeria and Niger.

In conclusion, most economic analyses at the project design level demonstrate the financial viability of a concept but not the economic viability as an investment for that country. Although project economic analyses are weak in terms of exploring alternative designs and their

intersectoral and micro-macro linkages, much of this type of analysis is done at the CDSS level. For most USAIDs, the CDSS is not developed in a project vacuum, including future project ideas. Projects do flow from a macro analysis of key development problems and constraints and most CDSS's define areas of U.S. comparative advantage as linked to those problems and constraints.

REDSO/WCA has taken several steps to strengthen our own capacity to service other Missions in doing project design economic analysis. Once each calendar quarter, REDSO/WCA conducts an Intensive Review Session (IRS) at which time staffs do not travel (thank God). IRS are devoted to reporting on country updates, including some macro economic analysis and project reviews under the Delegation of Authority 140. These sessions allow REDSO/WCA economists to interact with other technical staffs (and vice versa) and provides for the maximum professional scrutiny of project documents. Guidance on redrafting project documents, where appropriate, can be acted upon immediately. This is important especially where designs have been developed by contractors. In order to assist REDSO economists in field analysis, each PADS staff member has been equipped with a HP 23c calculator and we have developed a flexible software package for project analysis (PROJDRR--a Computer Model for Calculating Project IRR and Easily Performing Sensitivity Analysis by Dr. Douglas Barnett).

REDSO, AFR/DP and AFR/TR could, however, do much more to sensitize and train project design and management officers in the utility of better economic analysis for projects. We could do more to guide missions as to the types of data necessary for project economic analysis and devote more time--and money--for such designs. Our improved capacity to do project analyses and more in depth review of those projects has been applied to a diverse set of project environments such as grain marketing and storage (Congo) and off-farm employment (Togo).

II. Project Implementation, Evaluation and Redesign

In my experience, little explicit reexamination of project economic analyses is undertaken after PP approval. Too often the PP becomes a moribund document at approval. The new Africa Bureau guidance on evaluations may help to identify those projects which warrant a re-examination. Emphasis should be given to not only changes in key data but also the economic assumptions underlying project selection and design. We do little redesign of projects during their LOP and document redesigns even less. The country- and

project-specific situations dictate how elaborate an evaluation/redesign effort should be but a priori it need not be elaborate or costly.

Two interrelated events in Africa, especially in the Sahel, warrant a re-thinking if not a re-analysis of mission total portfolios and individual projects: (1) continued drought and (2) macro economic crisis. How to conduct such an analysis was the subject of an earlier panel (Day 1). The time is right to begin such a process; project and portfolio re-analyses should be tied to FY 85 ABS reviews, including the deob-reob authority and strengthened World Bank consultative groups or UN roundtables.

III. Two Parting Observations

Although improved economic analysis can assist in better project selection and design, we should not expect too high a return for our investment in this. Inappropriate technical designs (in terms of inappropriate inputs or inputs inappropriate to outputs), implementation problems, weak host country institutions, lack of supporting infrastructure, lack of financial accountability, lack of USAID monitoring, etc., and, above all, hostile policy environments will continue to frustrate project success.

Second, it is becoming fashionable in the Africa Bureau to argue for more nonproject assistance. This would relieve, it is argued, the management intensity of small scale, technical assistance projects and allow for more direct policy dialogue. The reasoning is very attractive to economists. Greater nonproject assistance will, however, significantly change the nature and detail of economic analyses performed in the WCA region. Economic analysis will become the direct subject of assistance (changes in relative price structure for example) rather than an ex-ante defense of a project concept. This raises three questions: (1) Do we, as an Agency, agree on the methodologies to implement such a change? (2) Do we have access to appropriate talent to perform these analyses in Africa and monitor country performance? (3) Finally, do we, as an arm of U.S. foreign policy, have a consensus to apply both carrot and stick in the policy arena?

USE OF A SPREADSHEET IN AID PROJECT ANALYSIS

by Jonathan A. Sleeper

A. Introduction

USAID/Cairo has the largest assistance program in the Agency: the next fiscal year's obligations are expected to reach over \$800 million, \$500 million of which is comprised of Handbook 3-type projects administered by about 50 project officers. This is an average of \$100 million per project officer, an amount which exceeds the entire portfolio of most grant assistance AID Missions.

In this type of environment, there is a great demand for economic analysis in project design but scarce staff resources to perform it adequately. The demand is due in part to this administration's continued emphasis upon policy context in the Agency's development programs. It is also due to the size and complexity of our projects in USAID/Cairo, which require an economic analytical framework in order to explain the project and impart a sense of the "bottom line" to the different components which comprise the project. In particular, the very size of our projects creates very high expectations for supporting analyses on the part of those who review our papers in Washington. This is very understandable, since many among our AID/Washington colleagues themselves come from smaller grant assistance AID Missions where the idea of a \$150 million agricultural research and extension project boggles the mind.

B. Advantages of a Spreadsheet

In USAID/Cairo, we have found that the use of a commercially available spreadsheet program on a micro-computer has proven invaluable in meeting both the high expectations on the part of our audience in AID/Washington and Agency requirements for supporting analyses, at the same time overcoming the constraints of tight design schedules and limited professional and secretarial staff time.

The advantages are:

- 1) less paperwork. All data can be stored and manipulated within the micro-computer.

2) less calculation time. Once in the micro-computer, all calculations can be performed rapidly and accurately.

3) less production time. All data can be rapidly printed in the form of independent tables (with footnotes, etc.) of a quality suitable for direct inclusion into the text. We all know how frustrating and time-consuming it is to get tables typed accurately and well.

4) more flexibility. Assumptions can be changed anywhere in the analysis and re-calculations performed rapidly, thereby making sensitivity analysis quite easy (e.g., changes in quantities of inputs or prices of outputs or adjustments of "shadow" prices). This permits the rapid re-examination of original design assumptions, thereby permitting modifications in design which are more realistic and more workable.

C. Some Examples

The following are two examples of how we utilized a spreadsheet program in project analysis, showing the advantages of the program when performing sensitivity analysis and dealing with shadow prices.

Both frameworks described below were developed with the assistance of Dr. Carl Gotch of Stanford University, Dr. Ludwig Eisgruber of Oregon State University, Robert Morrow of the Near East Bureau, and Saneya Amin of the USAID/Cairo Agriculture Office.

1) The National Agricultural Production Program (NAPP). -- The National Agricultural Production Program is an attempt by USAID/Cairo to cash in on its investment in several applied research and development projects in the agricultural sector totalling some \$150 million. Under these projects, improved "technology packages" have been developed for the three major Egyptian cereal crops (wheat, rice, and maize), incorporating internationally-tested practices, but also tested under local conditions on a large number of farmers' fields. Under the National Agricultural Production Program, AID would fund an effort to take the packages off the research stations and demonstration fields and disseminate them nation-wide.

We began our analysis with per-feddan crop budgets (one feddan equals approximately one acre) which we set up using financial prices in a tabular format acceptable for final printing and inclusion into our text. Each price (e.g.,

out-put price, labor price, seed price, etc.) was then "connected" to a table of accounting ratios (see Figure 1), again in a format which was presentable for the final text. This then gave us the net incremental benefits and costs per feddan, which we connected to a table in which we made assumptions about adoption rates of the improved technology. We then computed the aggregate streams of net farm benefits and costs, which when added to our program costs (e.g., technical assistance, construction, etc.) gave us the aggregate economic benefits and costs for the entire project.

Using the present value function of the spreadsheet program, it was very easy to calculate the benefit/cost ratio and net present value of the project. By setting up a reiterative look-up table off to the side of the analysis, the spreadsheet can also calculate the internal rate of return within a limited range of values. Otherwise, the Program can quickly subtract the difference between net present value of benefits and costs at any assumed rate of discount, which of course will be the internal rate of return when the difference is equal to zero.

One of the real advantages of using a spreadsheet in this manner is that after you get the whole thing onto the computer, sensitivity analysis can be performed with great ease and rapidity. All of the analysis is contained within one file, with complete access between groups of data, and any part of it can be brought to the screen instantaneously. Thus, an assumption can be changed anywhere within the analysis, and the effect of the change on the project net present value is calculated automatically and appears in the final table of aggregate benefits and costs. In this particular case, we wanted to see in our sensitivity analysis how the adoption rate of the improved technologies nation-wide affected the availability of the project (see Table 1). We could rapidly adjust aggregate incremental farm benefits and costs over a range of adoption, thereby giving us a feeling for the "robustness" of our project (robustness being defined that the economic returns do not change substantially when you fiddle with the assumptions). Use of the spreadsheet also permitted us to incorporate at the last minute an analysis which showed the importance of including small-scale mechanization in the program to complement the technological packages (Table 1). Finally, by using the spreadsheet tool, we could easily make other important calculations, such as aggregate input requirements, aggregate program costs which were dependent upon the level of effort (i.e., number of farmers reached

Table 1

National Agricultural Production Program:

Sensitivity Analysis

<u>Assumptions</u>	<u>IRR^{1/}</u>
1. <u>"Best Case Scenario":</u> 100% production targets achieved by Year 5, 9 feddans applied nationally for every feddan under demonstration (100% area under improved technologies).	+50%
2. <u>Less Optimistic Scenario, without Small-Scale Mechanization:</u> 65% production targets achieved by Year 5, one feddan applied nationally for every feddan under demonstration (20% area under improved technologies).	30%
3. <u>Less Optimistic Scenario, with Small-Scale Mechanization:</u> Same as (2), but with adoption of small-scale machinery to reduce animal/human labor requirements during peak periods (eg., harvesting, threshing) and/or increase yields.	+50%
4. <u>"Worst Case" Scenario:</u> 40% production targets achieved, 0 feddans applied nationally for every feddan under demonstration (10% area under improved technologies).	8%

^{1/} The internal rate of return (IRR) represents the average earning power of money used in a project over its life. It is the discount rate at which the difference between net present value of benefits and net present value of costs is equal to zero.

under the program), or aggregate effects on national production. These latter calculations gave us a strong basis from which to argue our policy concerns that GOE budgetary allocations to the agricultural sector be increased in real terms.

2) The Small Farmer Production Project (SFPP). -- The second example is a somewhat more complex framework which we utilized for the economic analysis of our amendment to the Small Farmer Production Project, an on-going supervised credit project. Under the project, USAID and the GOE Principal Bank for Agricultural Development (PBDAC) provide loans to small farmers to finance a wide range of investments such as improved crop production packages, small layer batteries for family egg production, improved breeds of cattle and water buffalo, small cultivating and harvesting equipment, and so forth. USAID also provides technical assistance, training and equipment to assist the PBDAC to streamline loan approval, processing and accounting procedures, and train extension agents in helping farmers to adopt new technologies.

The entire framework (illustrated in Figure 2) is based upon assumptions we made concerning the loan mix, i.e., the volume of loan funds available for lending in each activity category (crops, eggs, etc.). This was not difficult, as information about number of loans made per year in each enterprise category and average loan size by category were available from project records. Thus, we could use our analytical framework to perform conventional economic analysis, but also for estimating number of loans and number of clients under the program.

Having established the approximate amount the project expected to disburse in each activity category, the rest was fairly easy. We made some assumptions about annual disbursements from AID to the bank under the project ("new money"), rates of loan repayment and what monies could be used more than once in any given year. Then we divided this number by the size of the various loans to get the number of loans. The number of loans were then connected to the tables of individual enterprise budgets, which in turn were connected to the accounting ratio table. Following conventional project benefit/cost analysis format, the program costs were added, and our results show up in our final aggregate table.

Note that the accounting ratio table used to convert financial prices to their "shadow" equivalents is very useful in the Egyptian context, where because of exchange

rates differentials but especially because of government policies in the agriculture and energy sectors, there is great divergence between financial and economic prices. For example, by switching this table in and out of our analysis, it was an easy task to examine the large spread between financial and economic returns on poultry and livestock loans (Table 2). This divergence is due to GOE policies providing an inordinate amount of import protection to the poultry and livestock industry, as well as other policies which depress the financial profitability of growing field crops which compete with the major feed crop (berseem, or Egyptian clover). As a result, we were confident in making the recommendation to the GOE that livestock loans be limited to the acquisition of improved cow and water buffalo breeds which utilized feed more efficiently.

Again, this sort of program has great utility for performing sensitivity analysis because of the capability to very rapidly recalculate present value of benefits and costs with changes in original assumptions. In the case of the Small Farmer project, one of the things we wanted to examine was the importance of technical assistance and training to the rural bank personnel and computerization of record-keeping, which would improve the systems of accounting and streamline processing and approval of loans. These improvements should enable a more rapid turn-around time of short-term monies (which are used for the majority of loans under the project), thereby permitting a greater number of farmers to take out seasonal crop loans in any given year. This increases the number of income streams generated under the project and subsequently increases the project's internal rate of return (Table 2).

D. Technical Note

It is not the "size" of the spreadsheet program that is important (i.e., number of columns and rows available) so much as it is the "density" of data the program will accept in conjunction with the amount of addressable memory of the micro-computer. In our work we used the Visi-Calc (tm) spreadsheet program with an Apple II+ (tm) upgraded to 128 kilobytes of addressable memory and a modest dot-matrix printer. Our rule of thumb measurement is that 128 K of addressable memory provides 5-6,000 cells in the spreadsheet. With Visi-Calc, this translates to about 20 inter-connected tables with roughly 10 columns of data each, printed in the 17 character-per-inch (compressed) mode. Compressed printing and graphics capabilities, as well as increased density of data, do not appear easily available on the Wang (tm) OIS system (used by many AID Missions) which utilized the Multi-Plan (tm) spreadsheet program and daisy-wheel printers.

Table 2

SFPP Amendment: Internal Rates
of Return for Farm Enterprises 1/

	<u>Financial</u>	<u>Economic</u>	<u>No. Loans Year 3 (rounded)</u>
Crops 2/	+50%	+50%	45,100
Eggs	+50%	+50%	3,800
Broilers	38%	5%	45
Pullets	37%	34%	40
Cow	49%	14%	1,350
Water Buffalo	46%	16%	5,300
Farm Equipment	+50%	+50%	2,300
Other (addition to broiler house)	50%	4%	<u>80</u>
			58,000

1/ The internal rate of return (IRR) represents the average earning power of money used in an enterprise over its life. It is the discount rate at which the difference between net present value of benefits and costs is equal to zero.

2/ Average of results for wheat, mazie, tomatoes, broad beans, and lentils.

SFPP Amendment: Sensitivity Analysis

	<u>Economic</u>
Project IRR	39%
Project IRR with 20% increase in berseem price	36%
Project IRR with 10% increase in project costs	35%
Project IRR with faster turn-around time for crop loans (1.8 times/year)	44%

ECONOMIC ANALYSIS OF PROJECTS

by Paul D. Morris

Assumptions Regarding Economic Analysis

- Economic analysis focuses on the quantitative aspects of costs and benefits, for measurement in monetary terms.

- This common definition is too narrow. Least-cost analysis (where benefits cannot be quantified) and analysis of the economic environment should also be included.

- Economic analysis is primarily concerned with ex ante, not ex post applications.

- It has been designed to measure growth (GNP) more than development (productive capacity). This long-held common concept of growth has overlooked several aspects of achieving growth such as: increased quality of employment, improved income distribution, and the provision of basic human needs. The definition of economic analysis should be expanded to encompass a reduction of individual poverty (i.e., actual improved standards of living), and thus approximate the more desirable "development."

General Considerations

What part has the economist and economic reasoning played in the early stages of project selection and development?

1. It is assumed that the substance of this inquiry can be paraphrased in the following questions: Where does economic analysis rank in the hierarchy of processes which influence project selection? Is economic analysis important to others, or does it tend to be ignored and remain under-utilized as a tool?

2. Initial reaction is negative. Economics has little or nothing to do with influencing project selection and the ranking of alternatives for implementation, for well known reasons both external and internal to the project.

External factors:

- Pressure at all levels of the Agency to

obligate and disperse resources in order to maintain a strong demand for funds;

- The need to implement AID/Washington suggestions, satisfy an evaluation currently in the spotlight, or initiate the follow-on or replication of an existing project frequently dictates the content, size, and location of the new projects;

- Interpretation of the Agency's mandate to focus attention and resources on the rural poor and the problems of placing food and income within their reach;

Internal factors:

- Technical capabilities and resources available in the areas of interest of the project components dictate the details of what can or cannot be done.

3. A qualified positive reply can be given, however, if one uses the definition of economic analysis employed by the Asian Development Bank. It considers the economic context of the country and the sector relevant to the project. These factors should have been addressed in the annual CDSS and CP process.

4. Is there demand for an economic analysis input? On paper, yes. Handbook III specifies the inclusion of economic analysis in the project selection stage, while projects alternatives are considered. Again in the PID and PP development processes is prescribed. However, in actual practice demand for economic analysis is doubtful.

5. What improvements could or should be made? The following questions can perhaps lead to consideration of areas in need of possible improvement.

- What percentage of the PIDs approved in AID/W give evidence of compliance with the Handbook III guidelines for early economic analysis?

- Is there passive acceptance throughout the Agency that economic analysis need not be an active aspect of the early stages of project identification and selection?

- Given the manpower and workload demand and supply factors in the missions, how can the project selection and PID development guidelines regarding economic analysis be implemented for a wide variety of possible project alternatives?

- Can the forthcoming Project Economic Analysis Handbook contain a discussion of how to adequately but briefly apply relevant aspects of economic analysis to early stages?

- Have members of the profession made economics unnecessarily difficult to understand by using a highly technical vocabulary, thereby discouraging its use?

- Do members of the director's office or the program and sector offices need guidance on how to effectively employ economists and economic analysis?

- Do economists need guidance regarding techniques that are effective in the presentation to others of economic concepts and analysis that will assist those individuals to better understand and utilize the project?

Is economic analysis of the Project Paper (PP) usually sufficiently thorough to explain the project? Can it be improved?

1. It is assumed that to "explain the project" means to explain the economic implications of the project. If not, then perhaps a preliminary understanding needs to be achieved. That is, what should be accomplished in the economic analysis section of the PP and for whom is it written?

2. The analysis is generally not sufficient to explain the project or even the economic implications of implementation. When economic analysis is not a vital part of project selection and design activities it is difficult for mission staff to elevate it to importance later at the PP stage. As a result this section of the PP often becomes merely a collection of numerical tables with little or no narrative explanation attached. On the other hand, it may become a highly technical narrative that most readers will not bother to struggle with. Frequently the economist will omit the assumptions on which his analysis is based, whereas their inclusion could facilitate a better understanding of the project and the analysis. Assumptions could be utilized as a cross check for consistency with technical aspects of the project. PP space limitations lead to placement of most of the analysis in the unread annex section.

Which types of projects do not lend themselves to economic analysis? Is there still a role for the economist to play in these projects?

1. One alternative is to follow the MDB's lead by placing public utility and social welfare services such as health and education projects in the difficult-to-analyze category and answer in the negative. However, under the broad definition of economic analysis which includes the process of describing the host country economic environment, a positive reply is appropriate.

2. For other reasons also there is a role for the economist. At a minimum, most of the economic costs of any project can be identified and analyzed even though reference to benefits may have to remain in the adjectival narrative format. A least-cost analysis still remains more informative than no analysis at all. Furthermore, the attempt and subsequent failure to develop an economic analysis (for all but incompetency reasons) should assist the decision-makers to clarify mission thinking regarding project justification through a process of elimination.

Specific Issues

How are macroeconomic conditions and factors linked to project economic analysis?

1. While a wide variety of linkages may exist, donor and recipient country policies constitute one of the major links. Political necessity to measure project effect exists within the donor community. The policy to measure has long been established. The early interpretation of macroeconomic needs, and the emphasis on growth (GNP, quantity) over development (capacity, quality) stimulated formulation of the present system of economic analysis. In return, that economic methodology for selection and designation of project goals and for measuring project success emphasized growth. It is reasonable to assume that if the earlier emphasis of the donor community at the macroeconomic level had focused on development instead of growth, economic analytical tools would now exist for effectively measuring the benefits generated by project components designed to accomplish the type of development referred to above. However, the relatively recent acceptance of the growth-development dichotomy, and a belated acceptance of the need for new analytical tools, leave that responsibility to the economists of today.

2. The specific policies of individual host countries (e.g., agricultural marketing and pricing) largely determine the macroeconomic conditions achieved in the the country. The policies significantly influence the degree of possible

project success as measured by the flow rate of benefits.

Does one estimate the distribution of project benefits among various population groups? Does that distribution affect the project design?

1. If this refers to the various population groups falling within a physical or sector oriented project area rather than to populations classified as inside or outside of the project area, the answer is no on both accounts. However, when the analysis contains an estimation of secondary and tertiary benefits, the distribution frequently extends to outside population groups, at least in the narrative portion. To a limited extent this reasoning has influenced project justification but not project design.

2. There are implied assumptions in the question that ought to be examined. One is that the project benefits can be successfully targeted according to population groups. Another is that targeting may be utilized to accomplish a reduction of poverty and redistribution of income within the society. The validity of those assumptions has been questioned by analysts who cite extensive project implementation experience. Their doubts are founded on the expense and difficulty involved in the enforcement of targeting. The redistribution of the society's wealth and resources is not accomplished without the determined commitment of those elite groups within the society which must relinquish the most.

If shadow prices are used, how are they estimated? Are indirect benefits quantified? How are discount rates determined?

1. Shadow prices have been used on a limited basis in Nepal projects for the following:

- foreign exchange (at or near the blackmarket rate);
- unskilled labor, following a national planning commission derivation, which considers the average number of days employed annually, with a result approximately 75 per cent of the low market daily wage;
- foodgrains, at world market prices plus adjustment for domestic delivery and subsidies;
- energy, at world market prices.

2. Indirect benefits have not been quantified but there have been consistent endeavors to identify and list them in the narrative portion of the analysis.

3. The program in Nepal is focused on agriculture in an agriculturally-based economy. A discount rate of 12 per cent, as suggested by the World Bank, has consistently been utilized. That rate is also comparable to rates of return in the domestic institutionalized financial sector.

Are the distinctions between financial and economic analyses clearly drawn? On what criteria is a project justified?

1. Generally the distinction has been clear in project documentation. Handbook III provides clear but not comprehensive instructions.

2. As for the decision criteria, the extensive number of variables associated with type and size of project makes it difficult to designate a consistent categorization. In those projects where an identifiable and quantifiable stream of benefits is associated with the costs for each individual component of that project, and where shadow prices for unskilled labor and foodgrains have been employed, economic analysis has generally dominated the decision. Conversely, in those situations where a relatively significant share of the project components have not produced measurable benefit streams, a favorable financial analysis for a few individual components appears to have constituted the main factor justifying the project.

Does one do systematic economic analysis in PL 480, housing guarantees, commodity import programs or other non-project instruments?

1. No, not unless the term "instruments" is broad enough to include reports containing analysis of host country balance of payments and budgetary status, as well as the preparation of background analyses to support reasoning and claims in the CDSS and in other programming documents.

2. There is frequently a requirement to analyze data for contribution to Embassy reports when the Embassy is lacking in appropriate economic personnel.

What is the role of economic analysis in the evaluation of projects? Are there links between ex ante economic analysis and ex post evaluation?

1. It is assumed that this applies to the linkage between the evaluation of an existing or completed project and the use of those findings in the economic analysis of a yet-to-be project, and not to the analysis and evaluation of the same project.

2. The comparison of idea and reality nearly always can serve as an important step in the refinement of analysis process, thereby reducing the margin of error in future efforts. However, a rigorous ex post economic analysis is rarely, if at all, part of the evaluation process.

3. Timing of the evaluation process is of importance. Project implementation delays mean that early or mid-term evaluations will frequently be carried out before an identifiable stream of benefits has appeared, and limit evaluation effectiveness for any follow-on project design and analysis. In some projects even the final evaluation may still have solid data to work with on the costs side only. However, pressure to avoid a gap in funding, or to minimize the bridging period, can result in the design and analysis of follow-on projects prior to the availability of an adequate and relevant evaluation of the predecessor project.

ENHANCING THE ECONOMIST'S ROLE IN PROJECT ANALYSIS

by Lee Ann Ross

I expect that my paper will tell most of you what you are already painfully aware of, that the impact of economic analysis on the AID decision making process is marginal at best. At the project level, economic analytical techniques, especially benefit/cost analysis, were developed to assist in selecting among projects. These techniques are supposed to allow for choices among several good ideas, and to lay the basis for more accurate comparisons of the costs and benefits of different projects, all of which are attempting to ameliorate different aspects of a country's development problems. Were the techniques applied to an array of possible projects, it would allow allocation of resources to those projects which yield the highest return. I have never seen the techniques used in this fashion in AID. Rather, we set a minimally acceptable rate of return and if a project meets or exceeds that rate, the project is usually approved. Intercomparison of benefit/cost ratios for several options does not take place.

Traditionally, economic analysis of projects comes only after a mission has decided which project it wishes to pursue. The analysis is often tangential to the design process and usually used to justify the project after the decision has already been made to go forward with the project. There are a myriad of reasons for going forth with a project, most of which are not economic.

The first document in the AID project process is the PID and these days, an approved PID is tantamount to an approved project. When economists enter into project analysis after PID approval, our job is to help make the most efficient use of resources within the project, not between projects. In this case, to be most effective, I feel that we have to be a full fledged member of the design team allocating full-time to the project development from the beginning. When we do this we have the opportunity to help shape the project, not just to justify it after the fact. Unfortunately, working full-time on project design is rarely possible for a mission economist. Most often, a design team is contracted, we keep in touch with the team as time allows, and we turn their final report into an economic analysis for the project paper. Other duties preclude our working full-time with the design team. Hopefully, there is

a contract economist on the design team who is asking the sorts of questions we would like to ask in order to design an economically sound project. Our own input into shaping the project is limited.

We AID economists can expect to continue to be directly and indirectly involved in benefit/cost analysis in various specialized areas. For example, in the past five years, I have had to work on economic project analyses for three rural roads, one trunk road, a deep water port, a ferry boat, participant training and staff development, renewable energy, malaria, diversified agriculture research, irrigation, private enterprise, water supply, and sanitation. It is extremely difficult to complete economic analyses on such diverse projects without adequate backup materials which would help us identify all the inputs to be costed, the benefits to be estimated, and the estimation techniques to be utilized. Often, this can simply be several examples of past economic analyses dealing with the topic of concern. At present, most of us in the field are at the mercy of the library resources available to us in country. AID/W has recognized the constraint that we face and is preparing a manual on project economic analysis which should go a long way towards solving this problem. I would like to urge that the process go one step further and identify for us and make available to us, a set of what could be considered examples of "good project analyses" for the various kinds of projects we deal with.

An example might help explain the utility I see in this approach. When I did the malaria project, I was lucky enough to find a file containing five economic analyses for AID malaria projects in other countries. A review of these analyses allowed me to develop an appropriate methodology for my analysis. It also allowed me to evaluate the possible parameters for the analysis and provided a quick lesson in how wide the variation in these parameters can be. The key variable in the economic analysis of malaria projects is the number of days of illness avoided per case of malaria. While our malariologist (one of only two who work for AID) maintained that a person would be out of work for no more than five days, one of the other projects counted six days of lost production due to illness and 25 days of fifty per cent reduced effectiveness due to debilitation, or a total of 18 1/2 days per case of malaria. Another project figured that a person would lose eighteen days of work per illness. Thus, these two projects counted about 360 per cent more benefits for days of illness avoided than we did. Since this variable accounted for about 65 per cent to eighty per cent of the benefit streams, these

projects' benefits exceeded ours by about 250 per cent. While all three projects approached the analysis with the same methodology, the variation in results was dramatic. All three projects were approved by AID/W in 1982 and 1983.

The point of the digression is to demonstrate the need to review analyses for projects similar to the ones we are working on in order to judge the appropriateness of our methodologies and parameters. Even when we are not carrying out the analysis ourselves, we need to understand the methodological underpinnings so that we can write intelligent scopes of work for a contractor to carry out the analysis.

I would like to move now away from the imperfections in our project analysis procedures to the larger question of how an economist can have an impact on program design and resource allocation within AID. To do this, we clearly have to start well before a project as such is identified and before a PID is approved. If our project work is often of marginal value at the project level, we can guide overall allocation of mission resources through the planning process. In AID, this generally means starting with the country development strategy statement. The CDSS should define what areas the mission wishes to work in based on an analysis of the development constraints and problems in the country and a review of what the host country and other donors are doing. The economist can have a significant impact on the CDSS in several ways. We should have gathered, commissioned, read and reviewed the necessary studies prior to the CDSS so that we will be in a position to offer sound judgments on the future direction of the mission program. This is the stage during which we come closest to making decisions among and between projects. Decisions are not made on the basis of rigorous economic analyses of an array of already designed projects. They are made on the basis of an analysis that is both economic and noneconomic (sociological, political and technical). I think better use of the mission economist would involve continuing analysis at two levels: macroeconomic and sector. Clearly, if the macro situation is bad or can be expected to deteriorate, or to pick up strongly, there are implications for the future direction of the AID program. At the macro level, the function of the AID economist is to provide an early warning system, to alert the mission to coming difficulties and opportunities.

The initial shaping of actual projects and the decisions as to areas in which to intervene within a sector is usually carried out in the technical office. This is an

area where the economist's input is again often rather marginal. The economist generally fades to the background during the time between the CDSS analysis and the formulation of PID ideas in the technical offices. Once a PID is formulated, the process of choosing among projects is finished and the economist's role becomes one of justifying the PID idea.

Since the PID is more or less the central point of project formulation, the question becomes how can the economist and the mission make better PID selections? An obvious avenue is to do more background work leading up to the CDSS. This process, sector assessment and analysis, involves the investigation and understanding of a sector in such depth that we can prescribe with some confidence the remedies which we think will be most effective. The prescriptions should grow out of a sector analysis process which sets a methodological framework, gathers and processes data and uses them to analyze the fundamental sectoral problems. Continuous macroeconomic and sectoral analyses are needed to identify opportunities, constraints, and priorities, and to measure cost and benefits with increasing precision. Absence of such a process guarantees suboptimal allocation of resources.

There is no way to quantify and interrelate the major problems and objectives and the constraints and obstacles which need to be removed without prior analysis. Without this step, our projects are shots in the dark which we can only hope are addressing the major problems within a sector.

With adequate sector analysis, missions and the host government have the analytical basis with which to rationally prioritize interventions within a sector. Sector analysis completed in a collaborative fashion provides the country with the capability to collect and analyze data and to make their own decisions now and in the future. By completing sector analysis in a collaborative fashion, both AID and the host country are more likely to use the resulting analytical findings for reformulating policy and resource allocation.

In the final analysis, better development performance depends on the host countries. Consequently, helping establish a sector analysis process to inform sectoral policy making and resource allocation may be one of the most useful things the mission can do.

In Sri Lanka, we have had two successes in sector assessment and analysis. The mission carried out a detailed

health sector assessment to determine whether it would be appropriate for us to begin a health project. After reviewing and analyzing existing data and conducting a thorough administrative analysis, we decided against any large new involvement in the health sector. In the agriculture sector, we have been involved in a very collaborative effort to complete an agriculture, food and nutrition strategy. The analysis which has gone into the strategy points to the need for continued detailed analysis of this sector to best allocate government development expenditures. Other examples of ongoing sector analysis sponsored by AID are the Madagascar macroeconomic analysis, the Zimbabwe population analysis, the Zambia and Rwanda agricultural analyses and the Sudan energy and natural resources sector assessment.

Sector analysis is also the first step in moving away from the piecemeal project approach towards more coherent sector support. Sector analysis leads economists to a better understanding of the development problems and allows the economist to better guide project and program development.

I do not think that the PID to PP to project approval process will change in AID; therefore I think that it is incumbent on us as economists to determine a path which will allow us to have more input into project selection process early enough to have an impact on resource allocation. I would maintain that a logical way to do this is through the sector analysis process I have just described.

SECTION FIVE:

PRIVATE ENTERPRISE DEVELOPMENT

Edward H. Clark

Jan Van der Veen

PRIVATE ENTERPRISE DEVELOPMENT AS A PILLAR:
AID ACTIVITIES AND ECONOMIC ANALYSIS

by Edward H. Clarke

Introduction

An important element in AID's series of policy papers--four pillars, sectoral (health, population), cross-sectoral (recurrent costs)--has been enhancement of the developmental role of the private sector in general and the process of privatization in particular.¹

This session will provide an overview of recent experiences, particularly at the sector and project level, in advancing private sector development and the privatization process. As described in a recent paper by discussant Robert Muscat, the experiences range between those where full-scale policy dialogue has resulted in extensive privatization initiatives on a number of related fronts to the encouragement of privatization in more limited contexts such as specific project implementation.² These experiences, also reflected in a March, 1983 interpretive essay by Jerome Wolgin, point toward a greater emphasis, at all levels, on reducing "unneeded hindrances" to market activities. Frequently, this means helping governments get out of the way, an unaccustomed role for a government agency.³

This is also the emphasis of AID's new policy paper on Private Enterprise Development, now being reviewed by the Agency's Senior Staff.*

The new policy paper stresses that "LDCs which have over-extended the role of the public sector and restricted the operation of the private sector have experienced slow growth, heavy budget deficits and rising debt burdens".

Second, based on several years of experience with private sector initiatives, the new policy paper places a

*Note: Other quotations in this paper are drawn from a revised AID policy paper on Private Enterprise Development. (March, 1985). This policy paper replaces two existing policy papers, entitled Private Enterprise Development (May, 1982) and the Bureau for Private Enterprise Policy Paper (May, 1982).

greater emphasis not only on policy dialogue to change LDC development strategies toward openness and a greater market orientation, but also specific programs to reduce or eliminate legal, regulatory and other constraints to private enterprise development.

In terms of Agency policy, this means that:

--"Project and non-project assistance which is primarily aimed at reforming policy should include complementary actions which institutionalize the reforms in the form of revised laws, regulations, and procedures."

--"Each project which provides assistance to the indigenous private sector must describe and analyze the relevant legal and regulatory structure which affects the outcome of the project. The project must also show how changes in this structure will occur as necessary in order for the project to achieve its purpose."

In addition, "specific projects or subproject activities which provide assistance for studies or advisory services to review or reform legal or other barriers are encouraged." An example where this kind of institutional analysis might be particularly appropriate can be illustrated in the context of current efforts to develop Agency-wide guidance on the funding of intermediate financial institutions (IFIs). Many observers of AID experience with the funding of IFIs would likely conclude that AID should avoid supporting new IFIs in financially repressed settings unless significant policy changes toward financial liberalization are taking place. In most cases, these would include not only fundamental policy changes toward the elimination of interest rate ceilings, but also subsidiary institutional changes which may be necessary to create economically and financially viable IFIs (not requiring subsidies). These subsidiary changes might include:

- reduction in taxes on interest and financial transactions that excessively raise the cost of financial intermediation and lead to the very large observed spreads between deposit and on-lending rates;
- a streamlining of regulations that inhibit securities markets and greater reliance on equity funding as well as inhibitions (such as line-of-business regulations) to diversification of activities by IFIs;
- changes in legal practices so as to expedite and make

more effective the enforcement of an IFI's property rights as they relate to its financial transactions.

These institutional changes not only affect the soundness of AID projects supporting IFIs but more broadly, the choices of what kinds of financial institutions to support; that is, the choice between public or government owned and controlled financial institutions and private development banks. They also seek to correct for competitive imbalances between public and private institutions which might otherwise result in continuing pressures for the subsidization of private institutions which find it difficult to survive in the light of advantages accorded state-controlled and subsidized enterprises. As instanced by a recent cable from Cairo suggesting issues for this Conference, this has become a rather pervasive problem in the design of strategies for assisting the indigenous private sector.

In addition to IFIs, there are many activities that AID supports to improve the institutional climate for private enterprise development and the privatization process. An example of a very imaginative effort, to which AID has lent great moral and some dollar support, are the studies of the Peruvian "underground economy" by the Institute for Liberty and Democracy in Peru. The Institute's⁵ activities, which have received worldwide press attention⁵, dramatize "the cost of the process" as something reminiscent of the interminable judicial processes of Dickens' Bleak House and the potential value of analyses that focus on the "cost of legalization" (or entry into the formal economy) as well as the "cost of remaining legal" (if successful entry were somehow to be attained). In view of these efforts and the emphasis on subsidiary policies, AID is currently embarked on significant, if somewhat less ambitious efforts, to stimulate "private enterprise profiles" which would look closely at the institutional and legal environment affecting private enterprise development, building in part on AID's successful experience with "social and institutional profiles"⁶ in many LDC program and project development settings.

The new Private Enterprise policy statement aims not only at better understanding of the institutional setting for private enterprise development, but also calls for a rather fundamental redirection in our modes of assistance. This would be accomplished in several important ways that could have significant implications for the way we go about conducting economic analysis in AID. These implications

involve a range of efficiency and distributional (including competitive) issues that can be categorized according to the following threefold dichotomy in the policy paper:

- First, the provision of direct assistance to the indigenous private sector.
- Second, private sector participation in the provision of traditional government services.
- Third, the process of privatization with respect to state enterprises.

I will briefly touch on the general thrust of the policy and its possible implications for the first two categories and then elaborate more fully on the third category, raising some issues about the role of AID economists and economic analysis in the privatization process. These remarks will, I hope, provide a lively discussion among the discussants and the audience with respect to private sector development and privatization issues in each of the three categories.

In the first category (direct assistance), the policy paper states that, as a general matter, "AID resources should be channeled through the private sector rather than the public sector when host country conditions make this possible."

This general policy, in turn, has several corollaries concerning the provision of assistance (including training and technical assistance) that will improve efficiency and competition, and facilitate the transfer of new technology to a country while serving AID's target group. These objectives are also to be achieved through competitive processes that should not give one firm a significant competitive edge over another and will not have adverse effects on the marketing of new technology by the U.S. private sector through normal commercial channels.

The policy also addresses more difficult issues regarding capitalization of indigenous firms either directly or through IFIs. The issues relate not only to the "policy setting" and the subsidiary policies affecting financial transactions briefly discussed above, but also to the precise means by which AID seeks to ensure additionality in the capital base of existing institutions that will, in fact, translate into additional on-lending to a specific AID target group.

Finally, implementation of the policy must ensure that any concessionality (to government entities) is in exchange for policy reforms and that on lending is part of a planned effort to achieve market terms in LDC capital markets. On lending should not involve ministries or parastatals in the approval process where that involvement does not already exist and should seek to extract them from the process where they are so involved. Finally, the policy must address the concessionality which may be warranted to finance the (often difficult to estimate) extraordinary start-up cost associated with a new venture or activity which should be linked to advisory services and training.

Against this background it would be useful to consider proposed guidance on directed assistance that will foster private enterprise development in terms of what role economic analysis can play, both in the promotion of economic efficiency and growth but also in the obvious administrative problems that arise from a shift from public to private in directed assistance programs. Obviously, the transactions costs of channeling resources or directing assistance to the indigenous private sector can often be greater than the administrative costs of channeling resources to or through government entities. But these relative transactions costs must then be balanced against a comparative assessment of the relative performance (private vs. public) in achieving developmental objectives.

Our discussion (Bob Muscat's in particular) will focus our collective attention on AID experiences that will show how the shift in emphasis from public to private is being most efficiently accomplished (and where it is not). So too, where do we lack the necessary institutional understanding about the workings of directed assistance programs affecting the indigenous private sector and how can we begin to improve our performance, both in Washington and in the field? What are the important tradeoffs in term of support for directed assistance programs to aid specific enterprises vis a vis efforts to improve the climate for private enterprise, including privatization efforts affecting the opportunities for private provision of traditional government services and the privatization of state enterprises?

In the second category (private sector participation in the provision of traditional government services), the new policy paper gives a particularly strong emphasis to the involvement in the traditional sectors of heavy AID involvement--population (e.g., social marketing of contraceptives), health care and education financing, as

well as traditional government programs such as agricultural research and extension.

Our discussion (Maureen Lewis' introduction in particular) can focus on how privatization efforts in these and other areas (such as transportation, water supply and sanitation, etc.) can be supported through good technical studies and joint field research with USAIDs, which has been ongoing in a number of countries. This research is aimed at ameliorating a number of significant constraints to privatization that can be traced to lack of knowledge of user response (demand patterns), the comparative costs of alternative delivery systems and financing options as well as adequate cost accounting of publicly supported activities, including patterns of cross-subsidization and pricing that inhibit efficient and equitable provision of services.

In the third category, I would like to focus attention on the process of privatization with respect to parastatals and government authorized monopolies. This is an area of policy that has been the subject of heated dispute and contention within AID over the last two years, and will be the focus of a continuing internal policy dialogue for several years to come.

As it stands, the policy paper places a particular emphasis on AID assistance to or through parastatals that would be strongly conditioned on the exposure of these entities to market forces and eventual divestiture. This is viewed as evolutionary process that would also include measures to improve the management and operational efficiency of parastatals with benchmarks for measuring progress toward market-based operations and divestiture. The policy would also consider the labor market implications of such a process and encourage the programming of AID resources to assist employees adversely affected by a transition towards privatization.

The Privatization Process: Role of the AID Economist

It is in this third area that I would like to focus my substantive (as opposed to introductory remarks) on the role of the AID economist in private sector development and the process of privatization. Also I anticipate remarks from Harold Lubell on the transitional problems that may be encountered when a country embarks on a serious program of privatization or deregulatory steps to encourage indigenous enterprise competing with state enterprises under systems that continue to afford differential advantage to the state

avored sector through taxes, subsidies, or other regulatory forms. In my remarks, I would like to suggest the potentially important role of economists in helping to set aside, where appropriate, the influence of competing dogmas on the question of public vs. private which has sometimes stifled creative debate and innovation.

In order to do so, it is also important to question some skeptical views (among development economists) about the limited relevance of economics to the privatization process that somehow views this process as outside the domain of "economics" or "political sociology." According to this view, the application of conventional "market failure" theories provides straight-forward guidance on when public intervention is appropriate and the remaining questions are political, tactical or managerial (e.g., non-economic questions).

One might counter (or better understand the reasons for this view) by observing that incomplete or adventuresome economics, particularly in developing countries, may have contributed to the dilemmas presented by the dominance of the state controlled sectors. In a recent article on the "Politics and Economics of Privatization," Samuel Brittain squarely places the responsibility for "creating the chaos" caused by overreliance on state control on economists and economic methodology. Brittain traces the problem back to the origins of the thirty year debate (1920-50) over "socialist calculation," the upshot of which was a widespread diffusion of rather optimistic attitudes toward the relative efficiency of state-owned enterprises (SOEs). In the view of many, SOEs could operate rationally to ape the textbook competitive norms, investing when yield exceeded the social rate of discount and pricing according to marginal cost.

This optimistic doctrine was well-received particularly in many rapidly industrializing LDCs where, at least until about 1968, there was a widespread view that nationalized industries outperformed private industries.

At that time, the doctrine ran into a basic theoretical snag that came from the study of the economics of politics (now known generally as the public choice/property right school) which argued the failure of information and incentive. The most straightforward example is that even if the national government can persuade the head of the SOE to try to price at marginal cost, what incentive is there to make costs as low as possible when cost savings don't accrue to those making them? More broadly, how does the

attenuation of property rights and opportunities for discretionary behavior (within the firm) create the potential for waste and inefficiency but also the consumption of substantial real productive resources in "rent-seeking," within the firm and among those factions that are able to impose their will on a firm from without?

A growing emphasis in the literature on problems of information and incentive is indicative of the role that economics can play, not in the further refinement of competing dogmas over public vs. private that lie at the heart of the "socialist controversy", but in the design of specific transitional strategies that will improve public and private performance. These strategies would rely on mechanisms that will fundamentally improve the pattern of incentives and the efficiency of search (and information gathering) activities directed toward the achievement of more clearly specified and limited goals for public enterprises.

Research into the theory of public enterprise behavior, for example, has shown how lack of clarity and the diffuseness of goals can reduce managerial efficiency, including the incentive for outside factions to intervene and for managers to reduce search activities below levels that would be otherwise efficient. These problems appear to be exacerbated, as Vernon and others have argued, the more dependent is a public enterprise on government for finance, in which case there is a greater capacity of the various factions of government to impose their will on the enterprise and increase the likelihood of their intervention.

In addition, the new emphasis on information and incentive has spawned a good deal of new thinking concerning specific mechanisms that can improve public/private performance in the achievement of more clearly specified social goals. Much of this new thinking has important, if often counterintuitive implications for managerial incentive arrangements within the firm and between the firm and those to whom it is accountable. An example of new thinking about internal firm relations is demonstrated by an article by Higgans, Faith and Tollison. From both a theoretical and empirical perspective, Higgans, et. al. argue that the frequent introduction of new managers (CEOs) from outside the firm is more efficient than policies which rely on hierarchical promotion from within. With respect to governance and control of the firm from without, I have recently shown how public goods/externality/natural monopoly problems can be overcome through the use of the new

incentive-compatible, demand revealing mechanisms to motivate private "franchise monopolies" to behave in accordance with socially desired goals, including the pricing of public goods (or those subject to increasing returns) at marginal cost and the efficient provision of information that consumer or outside controllers (presumably representing consumers) might otherwise lack.¹⁰ In my view, these developments should be useful in beginning to set aside current views that there is a theoretical dichotomy to be made between public vs. private, growing out of notions about theoretical "market failures" or alternative dichotomies that emphasize the failures of government and state enterprises deriving from problems of information and incentive. If somehow these theoretical/ideological distinctions can be laid to rest, development oriented economists can play a much stronger and more activist role in the shaping of market oriented organizations, public and private, in developing countries.

To do this, however, we need a greater appreciation of the potential opportunities that are being presented in a wide variety of reform settings as well as the appropriate role of a bilateral donor agency in seeking to exploit these opportunities in the face of often difficult political constraints. The emphasis in this concluding discussion is also focused upon the role of the AID economist in showing how specific mechanisms can assist in achieving improved efficiency (by the amelioration of political/distributional constraints) and the improvement of enterprise performance through improved information and incentives.

The first example, the reform of agricultural parastatals in Mali, also illustrates the importance of alternative modalities highlighted in the Muscat paper (e.g., a "soft path" toward reform through cooperation with a multilateral donors group rather than "U.S. meddling," trying to impose what may be viewed as radical changes through the conditioning of bilateral assistance). The "soft path," however, can gradually result in significant changes in subsidiary policies (e.g., in the functions and objectives of agricultural marketing boards, once the government is willing to consider fundamental changes in basic policies affecting agricultural production and distribution). As instanced by a recent study of agricultural parastatals in sub-Saharan Africa,¹¹ the Mali government in 1980 responded to the proposals of a group of donor countries to replicate a basic approach that was first discussed in Kenya (but not seriously pursued) that was oriented toward making the marketing board a buyer and seller of "last resort," accompanied by steps to clarify and

monitor its individual but discrete commercial and stabilization objectives. In the Mali case, the plan also dealt explicitly with some rather difficult distributional implications through a six-year transition plan that is aimed at an approximate doubling of production prices in key crops, substantial increases in consumer prices and a gradual reduction in consumer subsidy (from about 75 per cent of production price in one important crop to zero over six years).

To help implement this transitional policy change, "the donors pledged food aid on highly concessional terms for domestic resale by the government. The counterpart funds thus generated are specifically committed to subsidizing, over six years, the procurement and distribution of local food grains. Although starting from an incentive producer price, the objective is the gradual reduction in subsidy requirements as a result of substantial savings in marketing costs and progressive upwards adjustment in the consumer price to equal the overall costs." In addition to examples like the Mali transition plan, there are other instances where specific mechanisms have been adopted that promote the search for economic efficiency.

Bates, for example, has pointed to the adoption of fiscal reforms affecting agricultural marketing organizations in Uganda that were taken in conjunction with important exchange rate reforms affecting performance of the agricultural sector. In an analysis of "the Fiscal System of the Board," Bates pointed to fiscal changes that eliminated fixed costs (and related subsidies to cover these costs) from the calculation of pricing policies, thus motivating managers to seek to maximize revenues less variable costs.¹²

In other work looking at the experience with privatization and divestment of SOEs in developing countries,¹³ we have become increasingly better educated as to the potential role of alternative control and decision-making mechanisms in achieving a gradual process of privatization and enhancement of market forces that will stimulate improved SOE performance. This understanding has also been enhanced by sectoral studies--for example, telecommunications development, which have looked carefully at institutional structure and the patterns of incentives and constraints affecting the performance of SOEs in particular markets.¹⁴ These studies emphasize the potential role of expanded competition in selected segments of the market as well as the potential adverse impacts--on technology transfer and the infusion of foreign capital--

that result from certain existing patterns of cross subsidization as well as possibly overly-broad regulatory powers accorded PT&Ts that are, in turn, motivated in their individual interests to use these powers to suppress competition and market forces.

Studies of privatization process have also led to an increased interest in specific reform measures, aimed at overall control of parastatals, that could either enhance or detract from long-term improvements in efficiency. Good examples of current interest include a comprehensive effort at parastatal reform in Tunisia¹⁵ and an interesting experiment in the measurement of the profitability of public enterprises in Pakistan.

In the Tunisia case (aimed at reform of some 500 public enterprises, of which two-thirds are production or marketing units and the remainder are financial enterprises), the State proposes to create a new Division of Public Enterprises in each ministry responsible for supervision of the most important enterprises. The purpose is to check bureaucratic intervention in enterprise performance, although it is not clear exactly how this decentralized approach to dealing with the coordination problem is to work, particularly in light of the double tutelle which subjects SOEs to oversight by the Ministry of Finance and the relevant technical ministry as well.

More appealing features of the plan include the increased use of the contract plan which will be used to establish clearly defined objectives for each industry. To encourage improved performance, managers will be given five year renewable contracts with performance criteria built into their contracts.

The plan would also reduce the day-to-day interventions of Boards of Directors (made up largely of Ministry representatives) who would be replaced with permanent administrators devoting full time to seeing that the Boards are fully informed on the problems of the industry they head and who would also become the Chairman of the Board as distinct from a CEO.

Finally, a key element of the Tunisia plan will be the creation of development banks to promote industrial and commercial projects in association with the private sector. These will be SOEs designed to disburse capital and appraise the actions of the private sector. It is expected, that once established, these banks (and their private sector partners), will in fact become the managers of the now

existing state enterprises. In effect, this reform plan envisions the privatization of about two-thirds of all SOEs, but the plan is singularly lacking in any discussion of who will purchase them, at what price and under what conditions.

As a final example of some of the intriguing developments in this area, I might mention a recent presentation at the World Bank's Public Enterprise Unit by members of the Experts Advisory Cell of the Ministry of Production of Pakistan on the subject of measurement of the profitability of public enterprises as compared with private enterprises in the same industry.

The Cell has worked out an interesting methodology for making comparative evaluations that are, in turn, tied to a performance evaluation system for managers of SOE's in which national goals are translated into explicit enterprise objectives or targets and quantified into performance criteria. A second aspect of the performance evaluation system has been an incentive system for managers (in five categories, A-E) where continued E ratings result in managerial shake-ups or dismissals, and good ratings result in bonuses designed to provide rewards comparable to those for successful management in private industry.

As a final note, one might speculate on the future evolution of divestiture efforts that may follow from these first steps toward improved management and control. In widely different cultural contexts and circumstances, it is conceivable that the evolution might take a significantly different form from that associated with privately owned regulated enterprise in the U.S. In fact, in many countries (particularly in Francophone countries), there appears to be a growing interest in expansion of existing arrangements for contract management toward more full-blown privatization through "concessionaires" and "franchise monopoly."

This interest has some parallel in the U.S. where there has been a growing interest in franchise monopoly techniques in the provision of traditional public goods and services,¹⁶ accompanied by efforts to demonstrate its applicability to the provision of a wide range of public goods and services in LDCs.¹⁷ In my view, there is tremendous practical potential for expanding this kind of basically competitive institutional arrangement, particularly if we can begin to overcome current distinctions between public finance and private provision, taking account of recent breakthroughs in the design of governance mechanisms that can drive public enterprise and private "franchise monopoly" (for public services) toward

reasonably efficient social outcomes in both the finance and provision of services usually relegated to the public sector.¹⁸

As a first step, however, the proponents of broad-scale privatization of traditional government services call for the same types of comparative analyses that are being undertaken (for State enterprise) by the Experts Advisory Cell in the Ministry of Production in Pakistan, accompanied by the careful analysis of patterns of cross-subsidization, and incentive arrangements, that affect the provision of public services and infrastructure.¹⁹ However, it has been observed that this comparative analysis of the relative efficiency of institutions may, by itself, be insufficient to change the political dynamics governing technocratic choices of bureaucracies.²⁰ Rather, we may have to pay closer attention to the system of governance and fundamental decision rules, traditional and non-traditional, affecting the behavior of these institutions.

Footnotes

¹ A conventional definition of privatization (which has been used to structure, in part, the agenda of this session) is an increase in the proportionate role of either or/both private production or private finance in any particular activity (the straightforward examples being the contracting out of activities financed publicly or, in the case of finance, user charges which better reflect the benefits received from publicly provided services.)

² R. Muscat, "AID Private Enterprise Policy Dialogue: Forms, Experience and Lessons," Paper prepared for the President's Task Force on International Private Enterprise, February, 1984.

³ J. Wolgin, "The Private Sector, the Public Sector and Donor Assistance in Economic Development: An Interpretive Essay," AID Program Evaluation Discussion Paper #16, March, 1983, p. 52.

⁴ On these points see Wilfried E. Kaffenberger, Business Strategies for Development Finance Institutions (September 1984); James A. Hanson, Development Banking and DFI Strategies in the 1980s (September 1984) and David L. Gordon, Development Finance Companies, State and Privately Owned: A Review (World Bank 1983).

⁵ C. Rosett, "How Peru Got a Free Market Without Really Trying," Wall Street Journal, January 27, 1984.

⁶ AID/PPC/PDPR Annual Budget Submission, FY86 (June, 1984).

⁷ S. Brittain, "The Politics and Economics of Privatization," Political Quarterly, April-June, 1984.

⁸ B. Levy, "A Theory of Public Enterprise Behavior," Research Memorandum No.91, Center for Development Economics, Williams College, September, 1984.

⁹ R. Higgans, R. Faith, and R. Tollison, "Managerial Rents and Outsider Recruitment in the Coasian Firm," American Economic Review, September, 1984, pp. 660-72.

¹⁰ E. Clarke, Demand Revelation and the Provision of Public Goods, Ballinger Publishing Company (1980); J. Tozzi and E. Clarke, "On Information and the Regulation of Public Utilities", in Current Issues in Public Utilities Economics, Lexington-Health (1983).

- 11 Keene, Monk and Associates, "Agricultural Parastatals," Paper prepared for AID/PPC (September 1984).
- 12 R. Bates, "The Regulation of Rural Markets in Africa," AID Evaluation Special Study No. 14, June, 1983.
- 13 L. Cowan, "Divestment and Privatization of the Public Sector: Case Studies of Five Countries," Paper prepared for AID/PPC (December, 1983).
- 14 W. Guttman, "U.S. Telecommunications Policy in Sub-Saharan Africa: Determinants and Initiatives," Paper prepared for AID/PPC (August, 1984).
- 15 Government of Tunisia, Ministry of Planning, Vith Five Year Plan, 1982-86, Vol.I , pp. 277-295.
- 16 E. Savas, Privatization the Public Sector: How to Shrink Government, Chatham House (1982).
- 17 S. Hanke, "The Private Provision of Public Infrastructure and Services," Paper prepared for AID/PPC, (May, 1984).
- 18 E. Clarke, op. cit, Ch. V. The significant potential for reliance on franchise monopoly governed through demand revealing mechanisms permits much closer approximations to true economic efficiency rather than simple technical efficiency that is attained through contract management in the provision of services.
- 19 Savas, Hanke, op. cit.
- 20 L. Lamansky, review of Savas op. cit., Public Choice, Vol/ 43, 1984. The reviewer calls attention to the same failure of incentive in the proposed solution to the problems that public choice/property rights critics have used to argue "government failure" in opposition to "market failure" justifications of government monopoly.

STIMULATING SUBCONTRACTING RELATIONSHIPS:
AN ALTERNATIVE APPROACH TO DEVELOPING SMALL AND
MEDIUM SCALE ENTERPRISES

by Jan van der Veen

No one now disputes the importance of small scale enterprises in generating productive nonfarm employment, in contributing to an efficient overall economic structure, and in tapping otherwise underutilized resources.¹ In a number of developing countries, governments have explicitly recognized the importance of small scale enterprises, usually with the hope that a rapidly expanding small scale enterprise subsector will absorb what otherwise would be massive accretions to an already woefully underemployed labor force.² The government of Bangladesh (BDG) is such a government. But, as is true of governments in many other developing countries, the BDG is uncertain how to proceed. The global record of donor assistance to small scale enterprises is, at best, spotty.³ The activities of the major donors offer few useful models of enterprise promotion.

In fact there are really two basic models. One has emerged from fairly recent efforts to provide assistance to very small enterprises, or microenterprises. AID, through its PISCES studies project, has been in the forefront of these efforts. Crudely phrased, the microenterprises model generally has two linked characteristics. First, it addresses primarily a capital constraint (often a working capital constraint) in which potential beneficiaries are paying "exploitative" interest rates. Second, it often relies heavily on highly motivated group behavior (based, e.g., on a charismatic leader or a social movement) to absorb costs otherwise unwillingly borne by formal financial institutions.⁴ A number of interesting modifications of this model are being developed. But the limitations of this model are well recognized; it cannot readily serve even fairly unsophisticated enterprises that are larger than microenterprises and it is proving difficult to replicate.⁵

The second basic model typically involves the delivery of a package of credit and technical assistance directly to selected enterprises. This model has evolved from work done by the IBRD and the ADB, among others, with development

finance institutions that make term loans to large enterprises. In this model, the donor typically identifies worthy product lines and provides credit and technical assistance directly and through financial intermediaries to selected firms in these product lines. But the limitations of this model also are quite well recognized. Time and again, experience has shown that administrators, bureaucrats and bankers are lousy entrepreneurs; "identifying" worthy product lines is best left to investors. In addition, this model in practice addresses only supply side constraints (it typically leads to programs that offer credit--usually term instead of more sorely needed working capital--managerial training, infrastructure, advice on technologies, and so on). Marketing issues are ignored. But small enterprises seem to flourish best when product markets expand and appropriate policies are in place. In short, efforts to adapt to small firms the assistance packages originally developed for large firms are misguided.

Efforts to promote the development of small (and medium) scale enterprises by stipulating the emergence of, and by strengthening, efficient subcontracting relationships may prove far more successful. Under such a model, assistance is provided to the small firms indirectly and marketing constraints are attacked first.

Success stories abound, but are not recognized as examples of a generic model. For example, the diamond cutting industry, based on an extensive merchant-based subcontracting network extending north from Bombay well into Gujarat State, has emerged as the principal foreign exchange earner in India (roughly twelve per cent, in gross terms, of the country's total export earnings) and as an employer of roughly 300,000 workers (direct employment).⁶ The growth of the industry has been phenomenal; it was virtually nonexistent a mere fifteen years ago. In Thailand, the large multinational firm Charoen Pokphand has stimulated contract farming operations,⁷ for decentralized pig raising by small scale farm operators. A number of other well known examples involve contract-farm-like activities in poultry, eggs, tobacco, shrimp and vegetables. And in Bangladesh, in an example of the best known type of subcontracting relationship (industrial subcontracting), there is growing evidence of a subcontracting within the rapidly expanding garment export industry--an industry that is itself organized as a subcontracting industry with international marketing firms as "parent" firms.⁸

What is a subcontracting relationship? Contract production involves a parent firm that assumes

responsibility for a product that eventually is sold to a customer, and a subcontractor firm that is charged by the parent firm to undertake the whole or part of the work involved in producing that product. The "charge" referred to is embodied in a contract. A firm may be designated a subcontractor if fifty per cent or more of the value of its production is devoted to contract production. The subcontracting relationship is part of an ongoing, semi-permanent relationship. Contract production must be distinguished from production for the market.

As suggested above, there are three principal systems of subcontracting. They are merchant based (or putting-out) systems, contract farming systems, and industrial subcontracting systems. In the Bangladesh context, and probably in many other relatively labor surplus countries, stimulating efficient subcontracting systems makes sense. That context includes:

- very weak entrepreneurial traditions (save in the commercial arena);
- excessive reliance on administrative, rather than market, allocation mechanisms;
- a habit (donor influenced?) of designing and operating inefficient integrated factories;
- typically thin markets, often organized as monopolies or oligopolies;
- pronounced seasonal employment patterns; and
- dualistic labor markets.

In such a context, the binding constraints for many small scale enterprises are managerial. Few operators can successfully devote their time and attention to tasks in marketing, purchasing, technology, finance, labor relations and production. A successful subcontractor limits his concerns largely to production and to labor relations issues. Marketing is assured as part of the ongoing subcontracting relationship. The parent firm can provide--in its own interest--sophisticated or particularly scarce inputs; it can help on technological matters and normally provides at least some working capital. In a variety of ways, a subcontracting relationship limits the managerial constraint (rather than trying to overcome that constraint) otherwise felt by a small entrepreneur.

Accordingly, the most appropriate intermediary is typically a parent firm. A few large parent firms may be the relatively isolated nodes of managerial talent, technical expertise and political clout needed to get a broad range of industrial or commercial or agricultural

enterprises moving. Banks are particularly inappropriate when general capital constraints are not binding, as appears to be the case in Bangladesh.

Relations between a parent and subcontracting firm must be based on individual perceptions of self-interest. Each responds differently to different risk/returns situations. It appears that large parent firms are more risk averse than their normally smaller subcontractors, at least in industrial subcontracting relationships. Parent firms may have to be persuaded that accepting the increased risk involved in subcontracting (rather than doing the job inhouse) makes sense. Similarly, subcontractors may have to be persuaded that a relatively risk-loving strategy no longer yields returns as high as previously were expected. Accordingly, the policy context becomes especially important. Decontrolling prices will reduce windfall gains to many activities that now provide a major source of income to small firm operators. Dismantling licensing systems will reduce the rewards to currying favor with administrators.

These three elements are all important. Limiting constraints by working on relationships between firms (rather than addressing them directly through technical assistance programs), looking to large firms as intermediaries (rather than banks, for example) and emphasizing the policy context (in which actions based on perceived self-interest have considerable latitude) together amount to an alternative approach to promoting small enterprise development in Bangladesh. It is an approach that merits some attention even as existing methods are refined.

So far these arguments have been based on bits of scattered case studies (diamond polishing, some of Charoen Pokphand's activities, and garments) and abstract principles. Where do we go from here? USAID/Dhaka is now designing a small pilot project to explore the potential of an industrial subcontracting approach in the light engineering industry. Negotiations with the government are underway.¹⁰ The pilot will contain a discount facility (probably organized through a bank) in which credit lines will be made available to subcontractors with valid contracts from eligible parent firms. This technical assistance will be provided, in part, by the parent firm; AID support for the technical assistance would go, in the first instance, to the parent firms. Training also will focus on the parent firm and may provide for partial guarantees and declining subsidies both to prospective subcontractors (e.g., rehiring rights at the parent firm if

an employee of the parent firm decides to try to establish a subcontracting firm) and to the parent firm itself (e.g., partial reimbursement of uncaptured externalities including training costs).¹¹

In cooperation with S&T/RD, we also are bringing to Dhaka, in early 1985, an expert on subcontracting. He will explore all aspects of the potential for subcontracting in Bangladesh with particular emphasis on merchant based (putting-out) and on industrial subcontracting systems. We hope to tap into the Agency's considerable experience with revived (and recently revived interest in) contract farming when the timing is right. We hope to be able to report on these efforts to design interventions in the near future.

Footnotes

¹ The work of Liedholm, Chuta and others at MSU has been instrumental in disposing of earlier views to the contrary.

² There is, accordingly, some confusion between a small scale enterprises promotion strategy and a labor-intensive enterprises promotion strategy. The proper goal clearly is to promote labor intensive enterprises of all sizes.

³ See DAC, Report on Industrial Development in LDCs, 1984 (PARIS 22212, 6 June 1984). Although the DAC Report deals with industries, the same judgments apply to enterprises in general.

⁴ Well known examples of this model in South Asia would include the Grameen Bank (Bangladesh), Self-employed Women's Association and the Working Women's Forum (India).

⁵ Debates on the various definitions of microenterprises, small enterprises, and so on are tedious and pointlessly tendentious. For the purposes of this paper, in Bangladesh, small enterprises employ, with exceptions, from five to twenty persons.

⁶ Kashyap, S.P. and R.S. Tiwari, "Diamond Shaping Industry in Surat: Characteristics of Firms by Size," Economic and Political Weekly, Review of Management, 1984, pp. M99-M103.

⁷ See the paper on Charoen Pokphand based on the 1984 seminar sponsored by AID/W.

⁸ See the report by the IBRD sponsored HIID-A.D. Little Trade and Industrial Policy (TIP) reform project, Bangladesh Planning Commission, 1984.

⁹ Replicability is a crucial dimension. Targeted aid programs often are not easily replicable because the lessons learned in supporting, e.g., the manufacture of pump engines, are not readily transferred to, e.g., the production and processing of shrimp. The differences between credit plus TA packages to unrelated industries overwhelm the similarities. Only experience will show whether a program based on developing relationships between firms, e.g., subcontracting relationships, are more easily replicable. On the abstract level, it appears that replication will be easier.

10 As a result, the description that follows is highly tentative and subject to change.

11 A brief description of the draft proposed for the pilot follows as Attachment I.

DRAFT PROPOSAL: A PILOT ACTIVITY IN
INDUSTRIAL SUBCONTRACTING

This proposal will receive US\$400,000 from USAID/Dhaka for refinancing a subcontracting discount facility, for providing technical assistance and for auditing and evaluating the entire pilot activity and will receive undetermined complementary funds from BSLIC for financing other, largely administrative, components. If the results warrant expansion, additional funding would be included in a new USAID Rural Industries Project that may start in 1986.

Discount Facility (US\$350,000 AID funds):

Credit will be offered to eligible firms in a form that encourages subcontracting relationships. BSLIC will negotiate the creation of a discount facility where eligible subcontractors can discount their orders from any of a list of approved parent firms for immediate access to credit. BSLIC and a bank (Sonali has expressed some general interest in this field) could agree on the procedures for verifying the bills. Credit lines would be opened in favor of the eligible subcontractors. The pilot activity should be limited to a few areas; for example, Wari-Narinda, Tongi, Jinjira, and perhaps Mymensingh. Initial activity might be confined to Wari-Narinda. Details of this credit component proposal may be as under:

- BSLIC should compile a list of relatively large, potential or actual, parent firms that (1) are frequent customers of small engineering workshops, (2) possess good and verified (by their primary bankers) credit ratings, and (3) are willing to be part of this credit scheme;
- BSLIC should compile a list of eligible relatively small engineering workshops registered and unregistered, and (1) verify that they are legitimate business enterprises, and (2) assign credit limits to each firm roughly equal to two shifts full capacity production for three months or half the current market value of their owned assets, whichever is less.
- Owner/operators of these eligible engineering workshops would be able to go to the BSLIC discount office and discount, at 80 percent of face value, bills from their parent firms. Upon certified delivery of the order to

the parent firm, BSLIC will present the bill for immediate payment to the appropriate bank and refund the remaining face value of the bill to the subcontractor minus 0.05 per cent for each day (roughly equivalent to a twenty per cent annual interest rate) it is outstanding. BSLIC must deliver the payment to the subcontractor within three working days of its receipt of certified documents showing that delivery of the order has been made. If delivery is not certified within three months of the date of discount of a bill, BSLIC will insist that the subcontractor either (1) refund the original amount paid to the subcontractor (the eighty per cent of face value) plus 0.07 per cent for each day it has been outstanding or (2) post ten per cent of the original bill as additional security. If delivery is not certified within six months of the date of discount of a bill, BSLIC will insist that the money outstanding (seventy per cent of face value) be repaid plus 0.09 per cent for each day it has been outstanding;

- BSLIC will identify immediately all subcontractors who are in arrears to this scheme and will immediately (1) circulate the names of these firms to all banks and credit institutions in Bangladesh and (2) declare these firms ineligible for any further finance from BSLIC funds until the arrears are eliminated;
- Subcontractors who are availing themselves of this credit program must notify BSLIC if they are taking or propose to take any other loans. BSLIC may decide to make ineligible any firms whose credit worthiness has been impaired.
- If at any time the arrearages under this program exceed twenty per cent of the total amount due, the program will immediately be terminated, all employees dismissed, and the remaining portfolio liquidated. If the funds allocated for the credit component cannot be fully drawn within six months of the beginning of the program, the program likewise will immediately be terminated.

Other Components

Technical Assistance I (US\$20,000. AID funds):

USAID/Dhaka will provide a fund to finance one full time staff position in each qualified parent firm whose bills with eligible subcontractors account for more than Tk five lakhs of the bills discounted in the credit program. Each staff position would be filled by an officer who would

work closely with subcontracting firms and who would be charged with providing technical and managerial assistance to these subcontractors. The officer would be concerned primarily with quality control. The officer also would act as principal liaison between the parent and the subcontractor, facilitating the transfer of improved technologies and improved management skills. The officer may be able to help the subcontractor gain access to key specialized and scarce material inputs and reduce the bureaucratic delays that often ensnare smaller firms.

Technical Assistance II (BSLIC Funds):

BSLIC will provide funds to finance technical consultants, on a partial payment basis who will provide services on demand for subcontractors. To the fullest extent possible, these consultants will strive to strengthen the subcontracting relationship between their client firms and the relevant parent firms.

Training (BSLIC Funds):

BSLIC will sponsor seminars (designed with USAID cooperation) for key officers of the parent firms to familiarize them with the experiences of subcontractors in East Asia (notably Japan), South East Asia (notably Indonesia and Thailand), and South Asia (notably India). BSLIC will support short courses (designed with USAID cooperation) for key officers and employees of both the parent firms and the subcontractors to impart specific technical and managerial skills. It is expected that some employees of parent firms eventually will try to establish their own subcontracting firms. The training program will explore the usefulness of establishing partial guarantees both to the prospective subcontractor (e.g., rehiring rights at the parent firm) and the parent firm itself (e.g., partial reimbursement of the "training" costs incurred).

Audit and Review (US\$30,000, AID funds; and BSLIC funds):

BSLIC and USAID each will finance monthly audits of all the components of this proposal. Most attention will be placed on the credit component. The monthly audits will be completed within five working days after the end of each month.

Both BSLIC and USAID will subject the audits to independent review. USAID also will finance a local firm to be charged with conducting quarterly reviews of the pilot

activity. These quarterly reviews will assess the overall development impact on both parent and subcontracting firms and the industries involved.

The above draft proposal contains a number of elements which appear, at this stage, to be promising. Some elements may be dropped and others added, at a later date as we gain more experience. Elements to be added may include:

- a hire purchase scheme for subcontractors with particularly good track records;
- an institution that would act as a broker between prospective parent firms and prospective subcontractors;
- a fund to support consultancy efforts to identify profitable subcontracting opportunities in fully integrated corporations with excess capacity in certain operations; and
- a fund to support a shared (with the parent firm) equity subcontracting concept.

SECTION SIX:

ECONOMIC MODELING

Neal Cohen

Michael Crosswell

Yoon Joo Lee

James Elliot

THE SWAZILAND ECONOMETRIC FORECASTING MODEL

by Neal Cohen

Introduction

This note describes the Swaziland Econometric Forecasting Model. This model was developed specifically for the Fourth National Development Plan and was formulated for two reasons. First, it was designed for forecasting purposes, to provide information on the likely results of changes in the government policy and to better understand the interrelationship of the primary economic aggregates and thus the operation of the economy. The relationships which the model emphasizes are those that are useful to planners and provide information for economic decision making.

The note is divided into three parts. The first describes the methodology and formation of the model while the second part looks at analytical results. The third part presents the econometric model itself. The section on methodology involves a discussion on econometric techniques which is technical while the second part concentrates on the results of the analysis.

Methodology

The model was estimated by use of two stage weighted instrumental variables. Two stage instrumental variables is frequently used in multi-equation forecasting models when there is interaction between the equations and when the limited data available have been improving in their accuracy. Weighting is appropriate when there have been changes in the structure of economy and more recent observations ought to have greater weight in determining the accurate economic interrelationships.

After extensive discussions the key economic variables in the economy were determined. The economic relationships were investigated to determine likely cause and effect relationships. The statistical estimation techniques were used to establish the size and relative importance of the potential cause variables. For each equation a number of different formulations were attempted. These were analyzed for statistical as well as economic accuracy.

Before forecasting was done each relationship was examined. When it was felt that the economic relationship of the past few years was unlikely to remain valid in the future, adjustments to the relationships were made. An example of this is that the Northern Rail Link will influence the amount of income produced in Swaziland from transportation. The resulting adjusted model was then used to forecast the likely changes in the economy during the Fourth Plan period.

When accurate data were not available proxy variables which exhibit similar behavioral relationships were substituted. For many of the variables accurate data were only available for the last thirteen years. This meant that only a limited number of variables could be used in the estimation process and thus simplifying assumptions had to be made as to the nature of the economic interrelationships. Similarly, data limitations meant it was not possible for the model to completely capture the interrelationships in the economy.

For analytical ease the model was divided into six areas. Each focused on a specific area of concern during the Plan period. The first area is income and includes those items that make up Gross Domestic Product. The second area is government recurrent and capital spending, followed by an analysis of government revenue. The result of these two sections is a projection of anticipated government deficits. Next is a projection of price inflation, then imports and exports. The last section includes the equations in the employment area of the model and thus emphasizes the projected ability of the economy to generate sufficient jobs to meet demand.

The model used as its instruments all the variables which are exogenous to the model, that is, which are not predicted by the model and whose values are taken as given. This included rainfall in Matsapa and Mbabane, population, South African gross sugar prices. These variables were used in the first stage of statistical estimation to develop estimates of the variables which were to be forecasted by the model. The second stage used these estimates in a way comparable to ordinary least squares. This method is necessary in simultaneous equation models to reduce the statistical bias inherent in multi-equation models.

To take advantage of the improving accuracy of the data all the observations were weighted to reflect the gradual change in statistical accuracy. The weights used increased from 0.60 in 1970 to 1.00 beginning in 1980, with the

weights in between representing the "S" shaped learning curve. All financial variables were in 1980 Emalangeni. (The 1980 exchange rate was about .78 Emalangeni per dollar.)

In determining which equation to use in the model close attention was paid to the statistical properties of the coefficients (the t values) and the overall ability of the model to explain the variation and variance in the variable under examination (the R squared and R-bar squared as well as the F test). The Durbin-Watson test was used to examine the equation's error term for correlation of one error with the following year's error. The corrections that were used when the errors were correlated are discussed later. However, of greater importance was whether the coefficients made economic sense and whether the equation, when used for forecasting purposes showed an ability to accurately interact with the other equations and lead to believable forecasts.

Many times it was found that there was ingrained growth in a sector which could not be explained by traditional economic variables. This could be the workings of a long-term development plan (whether private or public), a gradual changing of attitudes or because of the inability of the model to accurately quantify the independent variable(s) which explain the dependent variable in question. Private and public bureaucracies tend to be self-perpetuating. Similarly, economic development sets in motion some forces which take years to mature, possibly for psychological reasons or because the results of an educational or training program takes time to influence economic variables. This ingrained growth is shown in the model by the use of a lagged variable. For example, the inclusion of lagged agricultural output to explain current agricultural output indicates that this year's output is partly determined by last year's output.

It was occasionally found that after the equation was estimated the errors (the difference between the actual values and the forecasted values as determined by the equation) were correlated with each other. Unless this problem was corrected, the model would over--or under--predict the future in a predictable pattern. This problem is called serial correlation. While there are a number of methods that can be used to correct this problem, one that can frequently solve the problem, and is the easiest to do, is to add time as a variable. The model uses the year (1970, 1971, etc.) as the measure of time. In those cases where this did not solve the problem it was necessary to

modify the estimation method in other ways such as the Cochrane-Orcutt procedure.

In addition to the equations which were statistically estimated there were a number of identities. Examples of these are that total gross domestic product is equal to the sum of its components; total tax collections to the sum of the different types of taxes; and total employment to the sum of private sector, public sector and informal employment. To make the totals accurate a separate equation was necessary to take into consideration the very minor elements in the identities. Thus, separate equations were estimated for the sum of the minor components to GDP, all revenues which were not explicitly estimated and those recurrent or capital expenditures for which a specific equation could not be formulated. These equations were necessary for completeness and accuracy in the forecasts.

After the individual equations were estimated the entire model was used to generate forecasts for the plan period. This necessitated making estimates of the value of the exogenous variables. It was therefore assumed that:

1. the projected increases in South African prices, income and mine production would be the same as generated in Late 1984 by the Rand Afrikaans University econometric forecasting model of South Africa;
2. international sugar prices were assumed to be stable at US\$0.12 per pound, this being the July 1983 level of prices for raw sugar on the London sugar market;
3. rainfall was assumed to be 75 per cent of the median level for the last five years as climatologists forecast that during the decade of the 1980's seven years will experience below average rainfall;
4. population growth rate is 3.4 per cent currently, but is projected to rise to 3.5 per cent during the plan period as infant mortality rates decline; and
5. the primary and secondary school enrollment projections of the Ministry of Education were taken as given.

There are a number of activities which the government has already undertaken which will be completed during the plan period. Since these changes are exogenous to the model, but influence the forecasts, it was necessary to adjust the model. The Northern Rail Link will be built primarily during 1984/85, with increases in transportation's contribution to GDP becoming evident in 1985/86. The model also assumed that the Havelock Asbestos Mine significantly reduces its operations in 1986. The Mpaka Coal Mine is

assumed to continue to operate without any major change in output. No adjustment was made for the proposed new coal or tin mines, or for the diamond explorations that are taking place. The model includes the new sales tax with collection of E15 million in 1984. Future collections will be the same proportion of real imports as is forecast for 1984. Since the results of the basic model forecasted an unacceptable high government deficit, the model was constrained to not permit more E10 million (in 1983 Emalangen) in net additional borrowing. This was assumed to force reductions in capital spending on items other than health or education.

The Equations

For ease of analysis and exposition the model was divided into six analytical areas:

1. macroeconomic income aggregates
2. government capital and recurrent spending
3. government revenue
4. exports and imports
5. price inflation
6. employment

In the descriptions which follow each of the behavioral relationships that make up the model is presented along with some of the implications of that relationship. Because there is a lack of lengthy time series some of the equations simplify the actual relationships in the economy. However, even if there were longer series available, the rapid change being witnessed, would reduce the value of economic relationships of the early 1970s.

The first analytical area is the macroeconomic aggregates. This includes all the equations that make up Gross Domestic Product (GDP). The purpose of this section is to understand the likely growth and composition of the productive components of the economy and understand the nature of the changes which are forecast for the economy. In addition, GDP and its sectoral components are usually critical in determining employment, imports and exports and the overall economic well-being of the economy.

The second analytical area presents the government's expenditure equations. It is divided into recurrent and capital spending. All the figures used are actual spending, and not budgeted or planned spending. The purpose of this section of the model is to gain an understanding of the likely direction of government spending if the expenditure patterns of the past carry into the future.

The third area presents government's revenue equations. The purpose here is to gain an understanding of the likely ability of the government to raise the revenue to pay for development and operating expenses without resorting to borrowing in excess of the current desires to incur debt. This area also gives some indication of the type of policy variables available to government.

The fourth area is the trade section and uses imports and exports as defined by the IMF for balance of payments analysis. A major difficulty faced by many developing countries is the inability to export sufficiently to pay for needed imports. While the problems are different here because of the link to the South African Rand, imports without exports (unless matched by grants, remittances or other currency inflows) will gradually lead to an outflow of money which would restrain developments. Only total exports and imports are included.

The fifth area presents the three price inflation formulas, and the last area presents employment data. The purpose of these areas is to gain a better understanding of the likely direction and cause of inflation and whether the economy will be able to develop the jobs necessary to meet the demands of those people seeking paid employment.

I. Macroeconomic Aggregates

The first area comprises the macroeconomic aggregates that make up Gross Domestic Product. GDP is the total value-added in all domestic production activities during a year. It is differentiated from Gross National Product (GNP) which includes net factor income from abroad.

There are a number of different ways in which GDP can be divided. Following U.N. guidelines the Central Statistical Office divides GDP into its productive components. This includes the total value of production which takes place in each of the following sectors: agriculture, forestry, mining, manufacturing, communications, and construction. Agriculture's contribution to GDP is the total value of all agriculture's production less whatever inputs it purchases from other sectors, or imports. The production of fertilizers in country is included under manufacturing and not under agriculture. Government's contribution to GDP is the total value of the salaries it pays. Government road construction is included under construction, as would be new hotel or restaurant construction.

The data for this section come from the recently completed study by the Central Statistical Office of the The National Accounts of Swaziland, 1975-1981. Older data were grafted on by using yearly growth rates.

The variables which explained each component of GDP and which had the appropriate statistical properties are:

Agriculture--The value of agricultural output is dependent on rainfall, the previous years output and time.

Because there is not a sufficiently long time series giving a break-down of agricultural output into SNL, TDL, and estate agriculture, this single component includes very diverse elements.

The previous years output captures the influence of those variables which influence output, but which could not be quantified with the data available, that is, expansion in output that has been taking place each year regardless of rainfall. For rainfall the results were that with an additional one thousand millimeters of rain, that real agricultural output would rise by E1.6 million. In 1980 this would represent an increase in output of 1.5 per cent. Time was included as a variable because of the problem of serial correlation discussed earlier.

Forestry--The total value of output of this sector is dependent on South African gross domestic product and lagged domestic forestry output.

While only a portion of the output of the forestry sector goes to South Africa, the output of that economy serves as a proxy for the demand of the rest of the world for pulp Usutu and for wood from the other estates. That is, the growth of the South African economy is a reasonably good indicator of the growth in demand by the various users of the output of this sector. A thousand million rand expansion of the South African economy (three percent in 1980) is projected to give rise to an E115,000 change in the Swaziland forestry sector (two per cent in 1980). The lagged forestry variable captures the trend in production in the same way as was true with the agricultural sector.

Mining--The total value of mining output is dependent on time and lagged output of mining.

Overall, the real value of mining output was down during the early 1970s. Because the country is a small producer of mined products it cannot influence market

prices. International prices influence investment which in turn will determine the quantity mined and thus earnings of this sector. As these prices exhibit some trend, the errors in the forecast were correlated with each other. The inclusion of time as a variable reduces this impact and improves the accuracy of the forecasts. In recent years, the physical quantity of output has not been materially influenced by the level of world prices or income.

Manufacturing--The total value of manufacturing output is dependent on the value of output of the domestic agricultural and forestry sector and time.

The manufacturing sector has three distinct components. The first are those industries that produce primarily for the South African economy. This includes the chemical, zipper, radio, and TV firms. The second type of industry services local agriculture. This includes the sugar refining mills, pulp and saw mills, boxing and packaging materials for citrus, and canning industries. A third type of industry is developing which services the previous two (engineering, repair, maintenance). At present only a few industries exist primarily to serve the local demand. Some of these industries are beer brewing, knitting, carpentry. However, overall for this sector, these activities are minor. A potential improvement for the model would be to attempt to divide manufacturing into different components. The time trend was necessary for statistical estimation reasons. It shows a slight upward trend in output, but most important in explaining the manufacturing sector is the output of the domestic forestry and agricultural sectors where expansion in the value of agricultural and forestry output calls forth nearly equal increases in manufacturing output.

Government--The total value of government's contribution to GDP is the value of the salaries the government pays. This is dependent on government's total revenue.

The element of government spending that gets included in GDP are the salaries of people who are on the government payroll. How many people are put on the payroll depends on the availability of funds to pay them. The model indicates that for every E1 million increase in government revenue (0.7 per cent in 1980) there is a E364,000 increase in government's contribution to GDP (0.6 per cent). At the real cost per employee that existed in 1980 this implies the ability to hire 130 additional people.

Distribution--which includes the value of output of hotels and restaurants is determined by the level of domestic gross domestic product.

This sector services both the needs of tourists (primarily from South Africa) and the needs of the people of Swaziland. No single sub-component of GDP was any better at explaining the output of the distribution sector than the overall level of production. A million emalangeni expansion of the economy (0.3 per cent in 1980) leads to an E85,000 expansion in this sector (2.4 per cent in 1980). While this is a small result, in terms of elasticity it reflects the high degree of development of the service component to the economy.

Transport and Communications--the total value of output of this sector is determined mainly by the level of government total capital spending and gross domestic product.

The main forms of transportation spending in the country have resulted from government capital spending. For example, government spending on new roads influences the amount being spent in the country on transportation; and similarly the government's spending on the telecommunications system influences the amount spent through the economy on communications in general. A ten per cent expansion of government capital spending leads to a 1.7 per cent expansion in transport and communication spending for the entire economy. Increases in the output of other sectors of the economy result in increases in transport and communication output. A ten per cent expansion in the economy leads to a 1.8 per cent expansion in this sector.

Construction--The total value of construction in the economy is determined by the level of total government capital spending (including salaries, equipment and materials) as well as lagged construction spending.

Government capital spending is significant in the construction sector in much the same way as in the transportation and communication sector. The lagged construction variable is needed to measure the impact of a built-in dynamism of the sector. That is, one construction project financed by the government, will have a multiplier effect throughout the economy as other people make expenditures encouraged or supported by the government's spending. The results show that for every ten percent expansion in government capital spending there is a 6.1 per cent expansion in construction activity. The lagged effect is such that a ten per cent expansion in 1982 consumption

activity causes a 0.2 per cent expansion in 1983 construction activity. This is a relatively low multiplier.

II. Government Spending

Government expenditures are actual, not budgeted or planned spending. They follow the IMF breakdown into functional categories which does not always exactly follow the budget. For example, education expenditures are included under a number of different expenditure heads. Education expenditures for the model include all education expenditures no matter which Ministry or office made them.

All government recurrent and capital spending aggregates are deflated to off-set the effects of inflation and thus appear in 1979/80 emalangen. To the extent possible all figures are actual spending as certified by the government auditor. The auditor has not been able to certify as accurate recent estimates of government spending. For these years treasury reports on actual spending are used. Budgeted figures were not used because of the wide discrepancies between planned and actual spending.

A. Recurrent Spending

Education: Spending on education was found to be dependent on school enrollment and lagged government total revenue. Spending in the education sector is seen to be demand related, that is, as the number of students increases, the government feels obligated to increase its spending for teachers and equipment. However, the number of new teachers that the Ministry of Education is able to hire depends only partly on the needs of the students, but also on the ability of the economy to generate the tax revenue to pay the salaries of the teachers. Each additional student increases real recurrent spending on education by the government by approximately E26. Over the past years the education sector has received about 11 per cent of the increase in Government receipts.

Health: Spending of health is dependent on growth in the population and time. An expanding population makes demands on the government to provide various health services such as clinics, health centers and hospitals. In the past every additional person has increased real government recurrent health spending by E5.25. The time variable was included because of correlation of the errors. Its inclusion improves the ability of the model to forecast spending.

General Government Spending: Spending on these items

(which also includes all Government spending not included under any other category in this section) is dependent on Government revenue and lagged recurrent spending. While cause and effect may be debated there does appear to be a relationship between increased Government revenue and Government spending. Examining the nature of the relationship through various lagged tests indicates that the likely direction is that increasing revenues lead to increased spending. The major explanatory variable is lagged recurrent spending where for every E1 million in real recurrent spending in one year there is a general government spending (support services) of E124,000 the following year.

Justice, Law and Order, and Defense: For justice, order, and defense spending much of the information in the previous paragraph holds. While the time trend is important, real spending has not been rising significantly over the past years when account is taken of the single extra large increase in spending which took place on 1978.

Agriculture: Recurrent spending on agriculture is dependent on total government revenue and a time trend. It was expected that the change in agricultural output might explain changes in agricultural spending by the government (that is, in a year when agricultural output declines there is increased pressure on the government to increase its spending on agricultural projects). However, this relationship could not be proven statistically and the analysis had to settle for revenue as an explanatory variable with an increase in revenue leading to a small real increase in spending. The time variable was included for statistical estimation purposes because of error term correlation.

B. Capital Spending

Overall capital spending was much more difficult to forecast. This may reflect lumpiness of past capital spending. The small size of the economy amplifies the effect of fluctuations in spending and makes the estimation of a smooth trend difficult.

Education: Government capital spending on education depends on primary and secondary school enrollment. As the number of students increases there is pressure on the government to build additional classrooms. For example, each additional secondary school student has called forth real capital spending of E410.

Health: Capital spending on health, like recurrent spending, depends on population growth. With the growth of population there is pressure on the government to increase its spending to supply health facilities. Each additional person increases real spending on health facilities in excess of E9.

Transport and Communications: Capital spending on these items is also determined by the rate of population growth. The increases in population increase the demands placed on government to provide additional infrastructure. At the same time there is an additional trend which increases spending. This time trend was included not because of error correlation, but to reflect rising expectations whereby over time people begin to get used to existing services and demand the next level of services from the government. With the large capital increases made by the government in the last decade the model projects that the marginal expenditure impact of an additional person at E19.

III. Tax Collections

The data in this section follow the breakdown which the Ministry of Finance uses and reflects actual receipts and not planned or budgeted receipts. The major revenue sources which are included are Customs Union receipts, taxes on income (including the individuals, company and the graded tax), and the sugar levy. For the Fourth Plan period an estimate was made of sales tax receipts. All other sources of revenue were lumped together and treated as a single group dependent on gross domestic product.

Customs Union Receipts: Statistically these are dependent on imports lagged two and three years. Real SACU receipts are equal to 10.8 per cent of real imports lagged two years plus 8.1 per cent of real imports lagged three years.

Personal Income, Company, and Graded Tax: These depend on the level of gross domestic product. As more extensive data become available it may be possible to analyze each tax separately. At present this is not possible. When analyzed together, the three taxes are slightly inelastic with respect to gross domestic product, that is, a ten per cent increase in real GDP leads to a 6.9 per cent increase in real tax collections.

Sugar Levy: This is determined by world sugar prices and domestic sugar output. This tax is based on a minimum international price for sugar. When the price is above that level then the levy is operative and the amount collected

will depend on how much above the target level the price is and the amount of sugar exported. As modelled, the tax is highly elastic with respect to international sugar prices (1.73) and inelastic with respect to domestic sugar production (0.15). This result is partly caused by some correlation between the two independent variables during the period being analyzed. However, since in the 1983-1989 period international prices are expected to be below the reference price, this tax is not projected to collect revenue.

IV. Trade Sector

Exports: Total real exports of goods and services depends on output from agriculture, forestry and mining sectors. (Attempts to include these, and the manufacturing sector separately led to unacceptable results because of the close relationship of the variables.) The major exports for the period 1978 to 1982 were (in declining order of importance), sugar, woodpulp, fertilizer, asbestos, canned fruit, citrus fruit, electronic equipment and sawn timber. This formulation of the equation does not include manufactured exports directly. However, as was established in the GDP section, there is a very close relationship between manufacturing output and production in the agricultural and forestry sectors, it does include increases in manufactured output indirectly. This equation ought to be improved over the coming years, and attempts will need to be made to disaggregate exports. Overall the model exhibits a slight export elasticity in that for a ten per cent increase in production there is an 11.4 per cent increase in exports. This shows the high export orientation of the economy.

Imports: These are dependent on gross domestic product and the government's total capital spending. The amount imported is based on total production that takes place in the society with a slightly elastic result, that is, as incomes expand imports expand by a slightly larger percentage (1.14). This exceptionally high result (nearly the exact same elasticity as for exports) is very unusual and reflects the unusually high dependence of the economy on imports, especially from South Africa. Statistically controlling for income, then if there is no change in income and a ten per cent increase in government capital spending there will be a 0.4 per cent increase in real imports. The model could be improved by disaggregating imports by SITC.

V. Prices

Three price equations were established. The first is

based on the "A" price index which is relevant for middle to high income people living in Mbabane and Manzini. The "B" index reflects the cost of living facing the low wage earning people living in Mbabane and Manzini. Both of these figures are collected by the Central Statistical Office. The third price equation is the GDP price deflator. This is a composite of the "A" and "B" indices.

All three price equations are dependent on the South African consumer price index and time (included because of error term correlation). In all cases prices in Swaziland tend to rise slightly faster than in South Africa, with a ten per cent increase in South African prices resulting in a 10.6 per cent increase in the Swazi "A" index, 12.2 per cent increase in the "B" index and 11.7 per cent increase in the GDP price deflator. This is due to deficiencies in the price indices themselves in that they exclude rent and the weights are not based on a Swazi household expenditure survey.

VI. Employment

While data are available for a wide range of different types of employment it was felt that the only accurate data that could be relied on were for the total amount of private sector paid employment and public employment. Informal sector employment was also modelled, but the results are considered to be less reliable.

Private Sector Paid Employment: This is dependent on the level of domestic production and a time trend. The economy's ability to generate private sector jobs is inelastic, with a ten per cent increase in production leading to a 4.2 per cent increase in private sector jobs (this would be equivalent to 2,300 jobs in 1980). While the time trend is slight, only accounting for an additional 0.4 per cent jobs per year (240 in 1980) it is still positive.

Public Employment: This depends on GDP and the level of total government spending (recurrent plus capital). There is near unitary elasticity (0.9) with respect to production, and for a ten per cent increase in total government spending there is a 1.9 per cent increase in public employment (this is equal to 380 positions in 1980).

Informal Sector Employment: This is dependent on output of the economy and a time trend. As was true with private sector employment there is an inelastic relationship with respect to expansions of production in the economy such that a ten per cent expansion of income leads to a 4.3 per cent

expansion of the informal sector (400 leads in 1980). There is also a very slight time trend expanding employment by 0.3 per cent per year (thirty positions in 1980).

The Forecasts

All the forecasts and financial figures are figures in real 1983 emalangi unless otherwise specified. (The 1983 exchange rate was about 1.1 Emalangi per dollar). All growth rates are figured on a compound basis between the actual 1982 results and the forecast 1989 figures.

The model was adjusted to reflect the reduction in output at Havelock Asbestos Mine, the completion of the Northern Rail Link, the proposed new sales tax (E10 million in 1984 and 2.8 per cent of the value of imports thereafter) and the desire of the government to limit the growth in its international debt to less than E10 million per year.

The exogenous variables, (those whose value is assumed and not forecast by the model) are South African income, prices and mine production, rainfall and world sugar prices. The projections for the South African economy were received from the Rand Afrikaans University Econometric Forecasting Model in late 1983. They projected income increasing by 2.7 per cent in 1984, with six per cent growth for the rest of the decade. For analytical purposes we assumed the same growth for mine production. South African inflation was projected to be 9.8 per cent in 1984 and then six per cent for each year from 1985 to 1989. Based on climatological forecasts of reduced rainfalls in southern Africa during the 1982, rainfall was assumed to be slightly less than the average for the last five years. World sugar prices were assumed to remain low, US\$0.265 per kilogram (US\$0.12 per pound).

The continuation of declining mortality rates and nearly constant birth rates will lead to an increase in the growth rate of population, from 3.4 per cent now to 3.6 per cent by the end of the decade.

Real income is forecast to rise by 2.2 per cent per year, but with a population growth rate in excess of 3.4 per cent per year, there will be a slight fall during the Fourth Plan period in real income per capita of 1.2 per cent per year on average. The major sectors contributing to the growth are transportation/communication (4.6 per cent), agriculture (3.9 per cent) and manufacturing (3.1 per cent). (The latter is high because of the forecast recovery in the South African economy leading to expansions in the Swazi

manufacturing sector). Towards the end of the decade agricultural growth is limited to 3.1 per cent per year. The reason for the high overall growth is because the sector comes back to a trend line after two years of drought conditions.

Unless the extraction of diamonds and tin begin prior to 1989, mining will contract by 20.1 per cent per year because of the reduction in output at Havelock Asbestos Mines. Forestry will also contract, at 2.9 per cent because of the slow downward trend at Usutu Pump resulting from a projected lack of new investment.

If real government recurrent spending increases in line with recent developments there will only be a 1.8 per cent per year real increase. Net interest and statutory payments will increase the fastest (3.8 per cent per year), and the demand for real recurrent expenditures on education will rise by 2.8 per cent per year. On the capital spending side the demand for educational spending is projected to rise by 9.5 per cent, while health expenditures will need to rise by 4.2 per cent. To constrain the government deficit to E10 million per year (1983 emalangeni) capital expenditures on transport/communications were limited to an annual growth of 1.4 per cent and other capital spending by 3.3 per cent per year on average. If it is not possible to constrain transport, communication or other capital spending, then the growth in education and health spending will not be possible.

Real government receipts are projected to increase by only 1.6 per cent per year for the rest of the decade with the largest increase coming from the new sales tax. In terms of 1983 emalangeni it is projected to increase its collections from E9.0 million in 1984 (E10 million in terms of 1984/85 emalangeni) to E19.6 million in 1989 (2.8 per cent of estimated imports from 1985 to 1989). Overall there is no growth in real SACU receipts for the entire period (caused by the unusually high 1982 receipts), with a slight downturn in 1983 and 1984. Real SACU receipts are growing by 2.7 per cent per year by the end of the decade. The sugar levy is not anticipated to collect any money as the projected price is below the target price for the tax to be imposed.

The result of revenues increasing by 1.6 per cent per year, and expenditures increasing by 2.5 per cent per year is a steady increase in the size of the government debt. Government debt was constrained to increase by no more than E10 million per year.

There will be a gradual expansion in the trade deficit. Imports will be increasing by 3.0 per cent per year, while exports are only projected to rise by 1.5 per cent. The deficit is thus expected to increase by 3.6 per cent per year. The deficit was 29 per cent of 1982 Gross Domestic Product; it is projected to rise to 36 per cent of 1989's GDP. This large deficit, if realized, will reduce the country's international reserves (including rands). While the reserves are currently sufficiently high to provide an adequate cover to finance imports, continued high deficits will reduce the amount of rands in circulation and thus act as a restraint on development. Thus, while it currently appears that the country will be able to finance the deficit, a dangerous situation is developing where the foreign exchange reserves might not permit the flexibility of action that has existed in the past. It is necessary for the government to begin considering ways to stimulate exports or restrain imports in order to restrain the reduction in foreign exchange reserves.

Employment is projected to increase by 1.7 per cent per year, with higher growth rate projected in the government sector (2.3 per cent) than in the private sector (1.4 per cent with 2.0 per cent in the informal sector). This means that with population and the labor force increasing by over 3.4 per cent per year that there will be a steady increase in the number of people unemployed. The modern wage sector will be decreasingly able to employ school leavers. In 1982 the economy could provide paid employment for 28 per cent of the people fifteen to 64 years old. By 1989 it will be able to provide employment to only 25 per cent, this translates to an increase in unemployment, compared to 1982, of 13,000 in 1989.

In summary the model is projecting gradual expansion of the economy, but not rapidly enough to provide jobs for the new entrants to the labor force, or a rising real income per capita. There is also going to be a constant pressure on the government caused by insufficient revenue and insufficient exports leading to forced economic restraint on the economy. The government will not have the excess funds required to engage in large scale employment programmes.

Alternative Situations

There are a number of variables which are outside the model, but whose values will influence the forecasts. These variables are not subject to simple control by the government. Rainfall may differ from that forecast by the model. South African growth or inflation may be different ,

from the projections, sugar prices may be higher than estimated and/or population growth may be different. In this section we explore briefly the influence these alternatives will have on the forecasts of the model.

If during the rest of the decade, rainfall increases to the long term average then agricultural growth will be increasing by 4.4 per cent per year and total GDP growth will be 2.4 per cent. By 1989 the result will be agricultural output which is 3.8 per cent higher than it would have been under the slightly less than average rainfall projections used in the basic model. This will increase the growth in government revenue by 1.3 per cent per year with a similar increase in government spending. There is a small increase in the number of jobs.

On the other hand, if rainfall is at the 1981/82-1982/83 levels then agricultural growth drops to 3.6 per cent and GDP growth to 1.8 per cent. Manufacturing, which had been projected to grow by 3.1 per cent falls to a 2.8 per cent growth because of the reduced availability of agricultural inputs. There is also a drop in the employment growth from 1.7 per cent to 1.4 per cent.

If South African real growth is 2 per cent in 1984, three per cent in the next two years and then 2.5 per cent per year for the balance of the decade, then there will be a slight reduction in GDP, almost all of which is in manufacturing. This will in turn reduce government revenues slightly which then reduces government spending.

If South African inflation in 1984 is eleven per cent with eight per cent for each subsequent year this decade then Swazi inflation will increase from 9.0 per cent average (for the GDP deflator) to 10.9 per cent for the entire period and be 9.5 per cent in 1989. Since the rest of the model was formulated in real terms, there is no significant effect elsewhere.

If the world price of sugar increases to US\$0.22 per pound (from US\$0.12 per pound used in the model which is the current world raw sugar price), then the sugar export levy will begin to collect money, if the reference price is not changed. In 1983 prices this tax will collect E14.5 million in 1989 and increase the total revenue by nearly ten per cent. This permits spending to increase, with the increase in spending going to capital spending on non-education or health related items. The increase in sugar prices also boosts GDP by two per cent and employment by 1.5 per cent by 1989.

Another exogenous variable is the population growth rate. The current projections are for a 3.4 per cent annual growth which gradually rises as the infant mortality rate drops. If instead of the population growth rate increasing, the growth rate drops to 3.0 per cent per year, then there will be some reduction in the demand for government spending on health services. While there will ultimately be a decrease in the demand for education, this decrease will not be manifest during the Fourth Plan period.

One general conclusion from this analysis of the influence of alternative values for the exogenous variables is that it is unlikely that they alone can result in a positive real growth in the per capita income. Similarly, even with optimistic values the economy does not appear likely to be able to provide the jobs necessary to employ the same proportion of school leavers as is currently the case.

COMPUTABLE GENERAL EQUILIBRIUM MODELS
AND SOCIAL ACCOUNTING MATRICES:

A BRIEF INTRODUCTION AND SOME LESSONS LEARNED

by Michael Crosswell

CGE's and SAMs

The purpose of this paper is to provide a brief introduction to "Computable General Equilibrium" models (CGEs) and to "Social Accounting Matrices" (SAMs), and then to indicate some of the possibilities and limitations of these tools. It is now recognized that SAMs and CGEs go together, in the sense that SAM provides the basic accounting framework for a CGE, and a CGE provides one tool for economic analysis of the information contained in a SAM. The initial section of this paper presents some very simple examples of CGEs and SAMs. The next section describes experience in applying CGEs and SAMs to Egypt and derives lessons learned. At the end of the paper is a brief note on references.

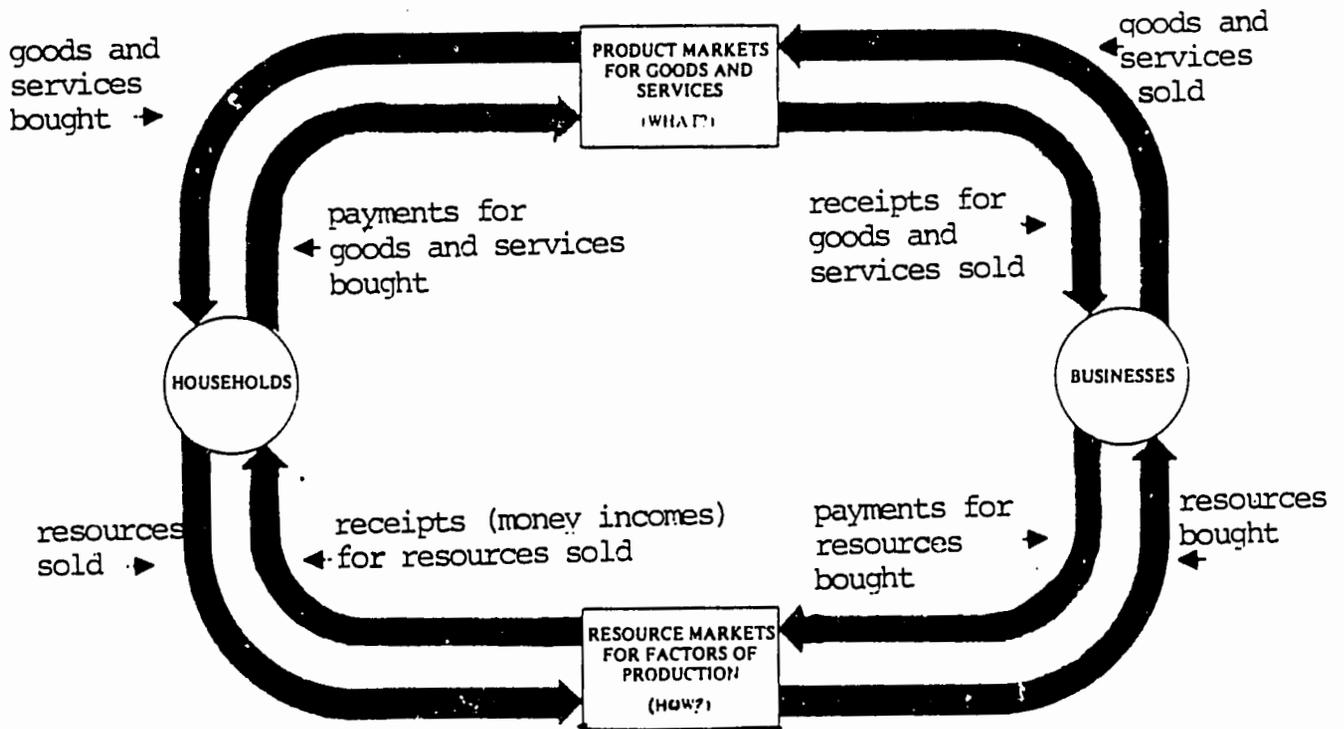
The simplest general equilibrium representation of an economy is the "circular flow diagram" that students encounter early on in most introductory economics courses. (See Figure 1). The diagram depicts an economy comprising households and firms. Two kinds of transactions go on between these institutions: households sell factor services to firms; and firms sell their output to households. Accordingly, there are two markets--for factor services and for products--that comprise a self-contained economy. If these markets are in equilibrium, the economy is in equilibrium. Corresponding to this general equilibrium "representation" of an economy is a simple social accounting matrix, i.e., a set of accounts (rows and columns) that represent an economy at a point in time. The basic rules for SAMs are that:

1. A SAM is a collection of accounts, with each account pertaining to an institution or market in the economy (e.g., households, firms).
2. For each account, there is a row and a column, so that a SAM is a square matrix.
3. Any particular cell in a SAM represents a payment from the column account to the row account. Accordingly,

**FIGURE 1. THE CIRCULAR FLOW OF ECONOMIC ACTIVITY
or HOW MILLIONS OF BUSINESS AND HOUSEHOLDS TAKE IN EACH
OTHER'S WASHING**

Households and businesses are linked through the product markets, where goods and services are exchanged, and through the resource markets, where the factors of production are exchanged. The questions of WHAT and HOW to produce are answered in these markets. Households act as buyers in the product markets and as sellers in the resource markets, whereas the reverse is true of businesses.

The outer loop shows physical flows in one direction, while the inner loop shows money flows in the opposite direction. (NOTE: The question, FOR WHOM? is not directly apparent in this chart because it depends not only on factor prices, which are determined in the resource market, but also on the way in which the factors are distributed in the household sector.)



the rows account for sources of funds and the columns account for uses of funds.

4. For any account, sources of funds (the row total) must equal uses of funds (the column total).

For the circular flow economy, the SAM would look like this:

	Households	Firms	Total
Households	-	Y	Y
Firms	C	-	C
Total	C	Y	-

In this matrix, Y represents payments by firms to household, e.g., wages. The variable C represents payments by households to firms, e.g., consumption. With income equal to consumption for households, and costs equal to revenues for firms, each account is in balance.

The SAM provides essentially the same general equilibrium representation of an economy as the circular flow diagram. Neither provides a formal general equilibrium model in the sense of a set of equations that describe the behavior of households and firms. In principle, a variety of different models could correspond to a given SAM such as the one illustrated above.

To move to a specific small general equilibrium model, consider the simple open-economy model commonly used in trade theory, in which an economy has two factors of production (capital and labor, in inelastic supply to the economy but mobile across sectors); produces two commodities (say food, Q1, and clothing, Q2); and engages in international trade at fixed prices. Demand behavior is incorporated as if there were one consumer in the economy. There is full employment of capital and labor.

The basic equations of the model include two production functions; four associated marginal productivity conditions reflecting profit-maximizing behavior; two constraints on factor availability; demand functions (for food and clothing); a budget constraint for "the consumer"; and a constraint that the balance of trade be zero. The model takes international prices and factor endowments as given. The first eight equations mentioned above are sufficient to determine the levels of production and employment (both K and L) in both the food sector and the clothing sector, and the prices paid for both capital and labor (r, w). In other words, the pattern of production and employment, as well as total income, are determined without reference to the demand side of the economy. The latter equations determine levels of consumption and trade such that total consumption equals income, and trade is balanced.

More generally, the model starts with some international prices, total factor endowments, production functions, and demand functions; and then determines the pattern of employment, production, domestic demand and trade, along with some domestic prices (r, w) and income. This is basically what all CGE models do.

This simple general equilibrium model is at the core of CGE's. Before describing the extensions whereby one moves from the simple model to a CGE, it is worth deriving the SAM that's associated with the simple model, as well as noting some of the economic questions that can be addressed by the model.

The model can be considered to embody six accounts: capital, labor, household, the food sector, the clothing sector, and international trade (ROW for Rest-of World). The SAM would look like this:

	K	L	HH	Q1	Q2	ROW	Total
K	-	-	-	rK_1	rK_2	-	rK
L	-	-	-	wL_1	wL_2	-	wL
HH	rK	wL	-	-	-	-	Y
Q1	-	-	P_1C_1	-	-	P_1T_1	P_1Q_1
Q2	-	-	P_2Q_2	-	-	-	P_2Q_2
ROW	-	-	P_2T_2	-	-	-	P_2T_2
Total	rK	wL	Y	P_1Q_1	P_2Q_2	P_1T_1	-

The SAM depicts an economy in which factor prices (w, r) are respectively uniform across sectors; the value of production equals total costs in each sector; all factor income (Y , or $GNP=GDP$) goes to the household sector; part of food production is exported (P_1T_1); clothing consumption is satisfied partly by domestic production (P_2Q_2) and partly by imports (P_2T_2); and domestic prices for output are equal to world prices. The balance of trade constraint and the household budget constraint are simultaneously satisfied.

Under some restrictive assumptions, the SAM provides enough data to fully specify a CGE. If both production functions are Cobb-Douglas with constant returns to scale, and if the demand system is based on a Cobb-Douglas utility function, then a SAM with nominal values (e.g., \$100) in the cells would provide enough information to specify a CGE.⁵ However, there are other specifications for production and demand that could produce the same SAM, and these might require data not contained explicitly in the SAM. (e.g., parameters for a CES production function).

It is worthwhile briefly reviewing some of the problems the simple trade model can address, to give an idea of some issues that more complex CGEs can analyze. These include: the effects of a shift in terms of trade or a tariff; the effects of a distortion in factor prices (but not a minimum wage); the effects of increases in factor endowments; the effects of various kinds of technical changes; the effects of changes in tastes; and the effects of a transfer of resources from abroad.

The typical CGE model extends the simple trade model (and the associated SAM) along the following dimensions:

1. Increasing the number of productive sectors beyond two, including some that produce non-tradeables.
2. Increasing the number of factors of production beyond two (to include land and various types of labor); and allowing for fixed allocations of capital to each sector.
3. Allowing for input-output relationships, so that production functions are usually linear with respect to intermediate inputs, and non-linear (typically CES) with regard to primary factors of production.
4. Increasing the number of household groups, so that poverty and income distribution can be analyzed.
5. Introducing savings and investment.
6. Introducing government, as a collector of taxes, distributor of transfers and subsidies, source of demand for goods and services, and a source of savings.
7. Introducing non-competing imports and downward sloping (rather than horizontal) demand functions for exports.
8. Introducing transfers and factor payments in the balance of payments.
9. Blurring the distinction between tradeables and non-tradeables by specifying imports that are less than perfect substitutes for domestic goods.

It is also worth noting dimensions along which the simple trade model has not been extended. While most CGEs incorporate savings and investment behavior, there are usually no markets for financial assets such as bonds,

domestic money, or foreign exchange.⁴ The price level is typically determined by an arbitrary normalization rule and, as in the simple trade model, relative prices are what matter.

Finally, it's noteworthy that the parameters for CGE models are usually not econometrically estimated, but rather "guesstimated" based on isolated observations (e.g., the sectoral shares of labor income in value-added contained in the input-output table; the budget shares for various classifications of goods and services contained in the most recent household expenditure survey; etc.). Perhaps the two most difficult data requirements are those for sectoral capital stocks, and for price distortions resulting from tariffs, taxes, subsidies, etc.

Experience with CGEs and SAMs in AID

During the latter 1970's the Office of Economic Affairs in AID contracted with Jeff Nugent and Charles Williams of the University of Southern California to develop a prototype CGE applied to Egypt. The underlying idea, stimulated to some extent by a mission to Jamaica in 1977 to program emergency ESF, was that in cases where AID was to provide program assistance with relatively little lead time for documentation, it would be helpful to have a general model handy which--provided data were available--could be used to help document the request and provide information on the expected impact of the assistance. The model was to be developed using readily available Egyptian data, but was to be in a form (a software package) flexible enough to accept any suitable data set, essentially a SAM.

The model that was developed had several fundamental problems. First, the model could be run with the Egyptian data, but did not readily accept an internally consistent data set, that had been formulated to test the model and the package.⁵ Second, the model was not sufficiently general in some respects, because of the peculiarities of the Egyptian SAM on which it was based. For instance, the Egyptian SAM contained no distinction between factors of production and household groups, nor did the model. At the same time, neither the SAM nor the model incorporated some of the distinctive features of the Egyptian economy, for instance the special distribution system that is the mechanism for food subsidies, which have been of particular interest to AID. Finally, the data base for the Egyptian SAM was unusually weak, even by developing country standards.

With respect to the latter problems, the IBRD and AID initiated a research project with the Ministry of Planning, Cairo University, and an associated research institute (the DRTPC) to produce a new SAM for Egypt and an associated CGE model or set of models that would incorporate institutional considerations specific to Egypt and permit a sharper focus on the policy issues of main concern in Egypt. Apart from these tangible outputs, the project intended to strengthen the DRTPC as an institution, and to promote closer cooperation between ministries that generated basic economic data and those institutions (both government and non-government) concerned with policy analysis.

The project was partially successful in that it generated a new, more up-to-date and more conceptually satisfactory SAM than the one that served as a basis for the Nugent model, and for other policy analysis in Egypt. However, it did not go as far as envisioned in producing a fully disaggregated set of accounts. A limited capacity to formulate and generate SAMs was established in the DRTPC, although this has been eroded by personnel changes. On the modeling side the IBRD economists on the project formulated an interesting model. However, there was virtually no progress in developing a useful model in Egypt, nor in enhancing the capacity of the DRTPC to formulate and use models.

The project provided an excellent vehicle for contact among government planning technicians, Egyptian university economists, and the chief economist in the AID Mission (Jerry LaPittas), who attended weekly meetings (evenings) with the core group of Egyptians involved in the project. A fundamental problem with the project was the unavailability of a suitable technical advisor to the project in Cairo on a continuing day-to-day basis. Instead, IBRD economists and myself were available only on a TDY basis. This problem was not so acute for the SAM work, but mattered a great deal for modeling.

Observations/Lessons Learned

Based on this experience, as well as on direct and fairly intensive work with CGEs in graduate school, I would make the following observations.

1. Even with excellent software (e.g., GAMS) an economist who wants to get involved with CGEs should be prepared to allocate a large chunk of time (minimum three full weeks?) just to get familiar with them. The best approach would be to build a small illustrative SAM (three

to five sectors, two factors, two households, a fairly sparse input/output table) based on "stylized facts" about production relations, demand patterns, price distortions, etc., and then to gradually expand and complicate the model and the data set.

2. CGEs are particularly useful as a learning device. They are especially good for testing whether theoretical propositions derived from smaller algebraic models hold up in more complex models. They are excellent tools for examining the quantitative effects of one or another specific distortion, in an economy that's distortion-ridden (e.g., second-best questions, effective protection issues, etc.). As long as we accept basic production and demand theory, they provide an extremely versatile framework for looking at a wide range of questions. They have been used to look at basic needs issues in an economy-wide context, and to examine strategies for structural adjustment.

3. Work on SAMs and, perhaps to a lesser extent, on CGEs can provide an excellent vehicle for institution building activities, and for promoting exchange among various groups of economists and technicians. However, it may be hard to find very many economists that have both the time and the aptitudes to become comfortable with CGEs.

4. There are fairly sharp limits to the direct usefulness of CGEs and (to a lesser extent) SAMs for AID program and policy dialogue purposes. They can be quite valuable as "illustrative" devices that show the broad directions of effects of one or another policy change. In particular, they can illustrate the wide variety of effects of a price change (say energy prices) on various productive sectors, household groups, the balance of payments, etc. However, they cannot reliably appraise the magnitudes of these effects, given the basic unreliability of the data; the need for arbitrary assumptions about some key parameters (including lots of elasticities of substitution in production and demand); and limitations on the capacity of CGEs to embody some distortions such as those associated with rationing.

For both programming and policy dialogue purposes, even relatively disaggregated SAMs and CGEs (e.g., more than fifteen productive sectors) do not provide adequate detail on subsectors and specific policy instruments likely to be of interest to AID.

5. Building SAMs, even when the basic data (an input/output table; a household expenditure survey; an

effective protection study;) are available, is very time-consuming and labor intensive. The basic components of the data set are likely to be somewhat out of date. Further data (e.g., employment and capital stock estimates or else some drastic simplifying assumptions) are needed to construct a CGE from a SAM. With an existing SAM, and a good computer package, the task is much easier.

Footnotes

- 1 See any text on trade theory, e.g., Murray Kemp, The Pure Theory of International Trade and Investment.
- 2 In terms of a graph, the model is represented by a production possibilities curve; an international price line (a "trading possibilities curve") that identifies the optimal production point; and an indifference curve that identifies the optimal consumption point and the associated trade pattern.
- 3 Note that a model builder is free to define units of K, L, Q1, Q2, etc. so that initial prices are equal to 1.0.
- 4 An exception is the model for Korea developed by Irma Adelman and Sherman Robinson in Income Distribution Policy in Developing Countries.
- 5 With respect to the software, the original idea of a prototype model was innovative, however, the finished product quickly became obsolete.
- 6 See Crosswell and Pleskovic, "Social Accounting Matrices for Egypt," Working Paper #1, Social Accounting and Macroeconomic Modeling Analysis in Egypt, October 1981.
- 7 See Wafik Grais, "Macroeconomic Effects of Efficiency Pricing in the Public Sector in Egypt," IBRD Staff Working Paper #726, 1985.

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On social accounting matrices see "What is a SAM? A Layman's Guide to Social Accounting Matrices," IBRD Staff Working Paper #463, June 1981, as well as the references it contains. More generally, Graham Pyatt has written several books and papers on SAMs, including "Improving the Macroeconomic Data Base; A SAM for Malaysia, 1970," IBRD Staff Working Paper #646, May 1984. (The lag in publication should be considered large, but still indicative).

On CGEs, the best single reference is General Equilibrium Models for Development Planning, by K. Dervis, J. DeMelo, and S. Robinson; Cambridge University Press, 1982. This contains both a general presentation and discussion, and some specific applications, including some financed by AID. See also the paper by Yoon Lee in this volume.

ECONOMIC MODELS FOR POLICY DIALOGUE

by Yoon Joo Lee

The following is a brief description of two types of economic models which have been used widely with regard to policy dialogue in many developing countries: two models for studies of incentives and comparative advantage (INCA) and a computable general equilibrium model (CGE). The INCA models include a model for analysis at the product/company level and a model for sector-level studies using input-output tables. While the CGE model provides an overall picture of the economy, it is very difficult and time consuming to collect the data required for this type of model, especially in the developing countries. Accordingly, the number of sectors included in the analysis is usually small. While the INCA models produce results of partial equilibrium analysis they provide information of the effects of tariff structure at a higher level of disaggregation: product level, company/firm level and/or at market level of the same type of products. The disaggregated information computed may also be aggregated at the subsector or sector level. These types of models are particularly useful for tariff reform.

The three models presented here are written in standard FORTRAN and would be utilized with limited computer skills.

An Inca Model for Microcomputers

The model calculates indicators of incentives (effective rates of protection and subsidy) and cost-benefit indicators (coefficients of domestic resource costs, economic rates of return on capital, net present value) at the firm level. Indicators of incentives are estimated under both the Balassa and Corden conventions for four distinct markets: domestic, preferential exports, non-preferential exports, and all markets. Cost-benefit ratios are estimated for four different modules: basic long-run, full-capacity, short-run, and incremental. The model has several built-in flexible features for purposes of sensitivity analysis and options for alternative methods for estimating capital costs, foreign factor of production, etc.

There are two categories of input data required for running the model: country specific and company specific. The country specific data include the shadow exchange rate,

social discount rate, shadow wage rate, decomposition coefficients of non-traded inputs and depreciation allowances; values and economic lives of fixed assets; and decomposition coefficients of fixed assets and working capital, etc. The program, composed of about 700 statements, could be used both on micro and mainframe computers.

The model has been used mainly for empirical studies as a background to policy reform (Structural Adjustment Programs in particular) in a number of developing countries, including Ghana, Ivory Coast, Mali, Morocco, Senegal, Tunisia, and Turkey and its application to several other countries is being considered.

For details of the model, refer to "An INCA Model for Microcomputers," Yoon Joo Lee, Industrial Strategy and Policy Division, the World Bank, June 1984.

An ERP Model Using Input-Output Tables

The model for estimating effective rates of protection (ERP) using input-output tables was prepared as a partial substitute and/or a complement to the INCA model described above. The INCA model, as indicated, requires that a detailed firm-level survey be undertaken. The survey normally involves large resources in terms of manpower, time and technical skills, not available for some research projects or countries. Though time and the budget situation may allow for such a task, researchers may want to have some preliminary estimates at the sectoral level or to compare these results to those obtained from the firm-level study. In addition, given the input-output tables for a few different time periods, the model could provide a description of the evolution of effective protection. It also provides decomposition coefficients of non-traded goods and depreciation required for the INCA model. The model has been used in several developing countries including Ivory Coast, Senegal, Tunis, Philippines, Thailand, Turkey.

The model estimates ERP under both Balassa and Corden conventions for three distinct markets: domestic, exports, and total. The data required for running the model are nominal rates of protection (NRP) of each I/O sector. In the absence of non-tariff restrictions on foreign trade, this parameter can be computed from customs codes. With non-tariff restrictions such as quantitative restriction and price control, price comparisons between the domestic and the world prices should be undertaken, a time-consuming task. The program was rewritten in GAMS in conjunction with

tariff reforms in developing countries. The main question addressed in this policy reform was: To achieve uniform effective protection across subsectors, what should be the nominal protection for each subsector or commodity? The program can be used both on micro and mainframe computers.

For details of the model, refer to "Estimation of Effective Rates of Protection," Yoon Joo Lee, Industrial Strategy and Policy Division, The World Bank, December 27, 1982.

A Computable General Equilibrium Model (CGE)

The CGE model was developed jointly by Kemal Dervis, Jaime de Melo, and Sherman Robinson of the World Bank. The model's particular applications are concerned with questions of growth and structural change, the choice of foreign exchange regime, and the impact of different development strategies on the distribution of income. The model, Walrasian in spirit, is in the tradition of economy-wide multisector models that have been used for development planning over the last two decades. It simulates the functioning of an economy by explicitly capturing the behavior of the various agents (households, firms, governments, rest of the world), the institutional framework (fiscal system and transfer mechanisms), and the market clearing process. The model has been used for short term and medium term planning and policy analysis as well as for the evolution of the performance and prospects of developing countries including Turkey, Ivory Coast, Cameroon, Korea, and Yugoslavia.

The model is designed to provide a description of the evolution of an economy over a number of periods, given the value of exogenous parameters and policy instruments. Within each period, it provides a set of equilibrium prices which leads to a balance of supply and demand for each market. Supply and demand for factors, commodities and foreign exchange are derived from each agent's optimizing choices and from the government's decisions.

There are two types of input data required for running the model: data needed for generating a social accounting matrix include sectoral output; value added, exports and imports; foreign capital inflows; the exchange rate; trade and export demand elasticities; prices of export and imports; consumption by the government and private sector; input-output flows, investment coefficient matrix; sectoral capital stocks, depreciation, investment, inventory investment; subsidies, tariff rates, tariff revenues by

sector, wage bill and employment by sector; etc. The direct input data include various flags (i.e., options) and parameters such as export supply, tariff rate adjustments, subsidy rate adjustments, income distribution, as well as sectoral total factor productivity growth rates; growth in world trade and exports; growth in world import prices and export prices; growth in labor force and real wages; etc. The program itself is composed of about 10,000 statements or five boxes of computer cards. It is now executable on the mainframe computers only and the possibility of using on microcomputers is being considered.

For details of the model, refer to General Equilibrium Models for Development Policy, Kermal Dervis, Jaime de Melo and Sherman Robinson, The World Bank, 1982. See also the paper by Mike Crosswell in this volume.

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POLICY SIMULATIONS WITH A MACROECONOMETRIC MODEL
OF A DEVELOPING COUNTRY - KENYA*

James Elliot
A.I.D.

Sung Y. Kwack
Howard University

George S. Tavlas
U.S. Department of State

Introduction

The econometric model of Kenya presented in this paper has been designed to describe a developing country that is small and open, in that the patterns and levels of economic activity and prices are predominantly affected by conditions in world commodity and credit markets where its own influence is minimal. To reflect these factors the model explicitly incorporates relationships between the monetary sector and the balance of payments. The export component of the foreign-trade sector has been disaggregated to emphasize Kenya's major traded commodities: coffee, tea, and petroleum products. Exports of coffee and tea are specified to be determined by world-market prices for these commodities and by outputs of coffee and tea, which are also, in turn, sensitive to world prices for these commodities.

The Kenya model has been estimated using annual data over the period 1968 through 1980. It has been estimated using ordinary least squares and consists of 143 equations, 53 of which are behavioral. The objective of our research is to provide a framework which policymakers can use to assess the impacts of alternative policies and shocks on the Kenyan economy.

This paper outlines the theoretical structure of the model and describes its simulation properties, including the effects of fiscal, foreign GNP, and exchange-rate changes on real GNP, and the current account balance. Policy

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implications and concluding comments are provided in the closing section.

Basic Features of the Model

The model covers four areas of major policy interest: output, employment, money and credit, and the balance of payments.

Output Determination and Employment

The real sector of the model determines the aggregate demand for goods and services, encompassing consumption, investment (including changes in inventories), and net exports of goods and services. Real consumption, C , is determined primarily by real income, GDP , and real money balances, $M1/PGDP$, in line with the life-cycle hypothesis. Real disposable income is assumed to be represented by real gross domestic product net of direct taxes, TVD .

Real gross investment, IK , is viewed as the process of adjusting actual stocks to desired levels of stocks. The desired capital stock depends positively on output, discounts and loans from deposit money banks, CL , and on government development expenditures, $IGDV$. The amount of bank loans represents the cost of borrowing as well as the supply (or availability) of funds, which constrains investment. Planned investment is realized with a time lag. Consequently, gross investment is specified as depending on output, bank discounts and loans, government development expenditures, and lagged capital stock. Real gross investment is disaggregated into four sectors, namely, agriculture, $IKAG$, industry, $IKIN$, non-government services, $IKSR$, and government services, $IKGS$.

The estimated coefficients on lagged capital stocks are low; actual stocks adjust to desired levels at a slow rate. This result seems reasonable given imperfections in transfer of information on the cost of capital and on capital markets. The amount of discounts and loans by banks is significant in the regression equations for gross investment in the manufacturing and service industries. This finding supports the view that the availability of funds is an important factor in investment decisions.

Changes in inventories, KII , are hypothesized to be functions of changes in desired inventory stocks. The desired ratio of inventory stocks to consumption is hypothesized to be determined by the rate of change of import prices in local currency, $FUM * EKL$, and by lagged

coffee output, $YAGC_{-1}$, and lagged tea output, $YAGT_{-1}$, reflecting the fact that the major commodities in Kenya's inventories are also its imports and major exports, and that rising import prices lead to anticipation of still-higher prices resulting in accumulation of inventories.

Net exports of goods and services along with net investment-income receipts from abroad are components of aggregate demand. The slight disparity in data between the national income and balance-of-payments accounts, due largely to a difference in the timing of recording transactions and errors in data, is corrected in the model by connecting the accounts via statistical means (i.e., by bridge equations).

While the expenditures and transfers of Kenya's government are treated as exogenous, its revenues are viewed as endogenous. Direct tax receipts are explained by the wage bill, $WR*LE$, where WR is the average annual wage in the formal sectors and LE is total wage employees in the formal sectors. Import duties, on the other hand, depend on the import bill, $MGV*EKL$, assuming duty rates, RTM , are exogenous. Indirect domestic tax revenues including taxes on exports are related to nominal consumption, CV , and nominal export levels, XGV . The elasticity of taxes with respect to a change in income was found, on average, to be about unity, implying that the tax system in Kenya, on the whole, is neither regressive nor progressive. Together with the tax equations and definitions of total tax revenue, government expenditures determine government saving. The size of the overall deficit or surplus in the government budget affects the monetary base.

In the model, aggregate demand for goods and services must be satisfied by output produced in the four sectors: agriculture, industry, non-government services, and government services. The allocation of aggregate demand among these four sectors is made to depend on the level of aggregate demand and on the relative prices of goods and services in the individual sectors. This approach is similar to the linear expenditure system used in explaining consumer demand.

Total employment is the sum of employment in each of the four sectors. The employment level of an individual industry is assumed to be determined by firms' demand for labor. Labor employed in industry and non-government services depends positively on output and negatively on real wage rates in these sectors. While a similar specification worked well for agricultural employment, the equation used

for labor demand in the agricultural sector reflects the dependency of that sector on foreign influences. Specifically, agricultural employment depends upon foreign GNP, FGNP, and the relative cost of labor in agriculture, WRAG, compared to foreign prices, FCPI. Employment in the government-services sector is assumed to follow government expenditures; hence, it is assumed to be exogenous:

$$LEIN = a_0 + a_1 YIN + a_2 (WRIN/PYIN)$$

$$LESR = a_0 + a_1 YSR + a_2 (WRSR/PYSR)$$

$$LEAG = a_0 + a_1 FGNP + a_2 (WRAG/FCPI)$$

where LEIN is employment in industry, LESR is employment in non-government services, LEAG is employment in agriculture, and WRIN, WRSR, and WRAG are the nominal wage rates in the respective sectors.

The Monetary Sector

The monetary sector explains the behavior of monetary aggregates and of loans and discounts of deposit-money banks. The balance sheets of the monetary authority and deposit-money banks are utilized explicitly in our model. Given the nonbank public's holdings of money, the monetary base of the monetary authority and the net-asset position of deposit-money banks determine the amount of loans and discounts available to the private sector. The aggregate money stock, M2, is broadly defined as currency, CUR, demand deposits, DD, and time deposits, TD. Public holdings of money are assumed to represent the amount of money the public wishes to hold to effect transactions. Hence, the amount of money demanded is related positively to real GDP.

The estimated equations show that the income elasticity of demand for currency is about 1.1, while the income elasticities of demand for demand deposits and time deposits are 1.2 and 1.6, respectively. These estimates are similar to findings in other countries and indicate that demand for time deposits is more elastic with respect to changes in income than is the demand for currency. Interest rates over the sample period could not be shown to have a significant impact on the demand for money.

The amount of discounts and loans to the private sector, CL, has been found to be primarily determined by supply conditions: monetary reserves, foreign liabilities and government deficits. In addition, the level of discounts and loans from deposit money banks is also

affected by nominal deposit rates and inflation. An increase in inflation or a decrease in deposit rates raises the demand for discounts and loans as the real cost of borrowing from banks is reduced. Hence, the following specification is used to determine the level of discounts and loans:

$$CL = a_0 + a_1 (RTC + CUR) + a_2 (CPI - CPI_{-1}) / CPI_{-1} \\ + a_3 RT + a_4 (FD + FS + FL) + a_5 GDK$$

where RTC is total reserves, RT is the exogeneously given interest rate on savings deposits, FD + FS + FL sum to foreign liabilities, and GDK is the government deficit.

The monetary base is composed of net domestic assets, NDA, and net foreign assets, NFA, of the banking system. Changes in net domestic assets are related positively to government budget deficits in the model. They are negatively related to changes in net foreign assets, suggesting that Kenya's monetary authority has acted to partially sterilize the effects of the balance of payments on the money supply, thereby stabilizing the growth of the money supply.

Price and Wage Determination

Our determination of prices follows a mark-up-over-cost approach in a stage-of-process framework. As Nordhaus (1971) has demonstrated, the optimal long-run price in an open economy with a Cobb-Douglas production function with constant returns to scale is:

$$p = z Q^1 W^{a_1} PM^{a_2}$$

where P is the sales price per unit of output, Z is a scale term interpretable as a mark-up fraction, Q is the index of Hicks-neutral technical change, W is the price of labor per unit of output, PM is the price of imported goods per unit of output, and a_1 and a_2 are the shares of labor and capital, respectively, in total sales. This formulation can be rewritten for estimation purposes as:

$$p = a_1 (w_t/q_t) + a_2 pm + z_t$$

where lower-case letters represent relative rates of change. The terms w and q are the respective wage and productivity components of unit labor costs, and pm is the unit price of imported goods. The scale term z, which can be viewed as a

mark-up fraction, is assumed to depend on the level of excess demand.

The foregoing specification of the price equation was used to explain movements in the consumer price index. For purposes of estimation, we entered the wage and productivity components of unit labor costs separately, and used the lagged value of the broadly defined money stock, M2, as the proxy for demand:

$$\text{CPI} = a_0 + a_1 \text{WR} + a_2 \text{PRODN} + a_3 \text{PUM} + a_4 \text{M2}_{-1}$$

where WR is the average annual wage, PRODN is labor productivity, and PUM is the unit value index of merchandise imports.

The sum of the wage (WR) and imported-price (PUM) coefficients was 1.08, or near unity, in conformity with theoretical considerations. In accordance with most empirical work on price determination, the productivity term has been normalized, in this case by taking a three-period moving average of output in industry divided by employment in industry, on the supposition that only permanent changes in productivity are passed on as price changes. The deflator for GDP in government service, PYGS, is estimated as a mark-up over wages and import prices.

The nominal wage rate is assumed to be determined as follows:

$$w = a_1 (1/U) + a_2 p^e$$

This expression consists of two components; the first is the response of nominal wages to unemployment, U. The unemployment response is the cyclical component of the equation and generates that part of the inflation process associated with the short-run Phillips curve. The second component of the expression is the feedback effect of prices on nominal wages. In lagged form, it can be interpreted as a proxy for either expected inflation or the role of inertia in the inflation process through the influence of multi-period wage contracts and other similar institutional phenomena.

Separate wage equations in the Kenya model were estimated for the agricultural, government, industrial, and services sectors. Only in the case of agricultural wages did we find statistically significant effects for both inflation and the unemployment rate. We found that wages in government and in non-government services are determined by

lagged consumer-price inflation. Wages in industry are determined by the current-period CPI inflation rate and productivity.

The Balance of Payments Sector

Commodity Imports. Real commodity imports are disaggregated into petroleum and nonpetroleum products. Petroleum imports MGOIL, make up a sizeable proportion of total imports and are an important input into Kenya's exports of refined petroleum products. Accordingly, petroleum imports were found to depend upon exports of refined petroleum products XGOIL, as well as on real GDP. We also found that the breakup of the East African Community (EAC), represented by the intercept dummy variable, D7780, had a negative impact on imports of petroleum. Specifically, the breakup of the EAC adversely affected Kenya's export market for refined oil products, a circumstance which contributed to a decline in crude oil imports. Imports of non-petroleum commodities, MGOT, are a function of real GDP, net foreign assets, NFA, divided by the exchange rate, and of the GDP price deflator divided by the price of other commodity imports, PMGOT.

$$MGOIL = a_0 + a_1 GDP + a_2 XGOIL$$

$$MGOT = a_0 + a_1 GDP + a_2 NFA/EKL + a_3 PGDP/EKL * PMGOT$$

Commodity Exports. Commodity exports are disaggregated into four categories: coffee, tea, petroleum products, and other goods. The model distinguishes between producer behavior and exporter behavior in the cases of coffee and tea in order to account for the institutional setting in Kenya. Specifically, exporting activities are carried-out by state-controlled marketing boards while production is undertaken by smallholders and privately-owned plantations which sell predominantly to the marketing boards.

Kenya's economy is a price taker in the world markets for coffee and tea. Accordingly, while changes in world prices for these products affect respective production levels, domestic production, in turn, affects export levels. Coffee exports, XGCF, were found to depend upon the output of coffee, the coffee terms of trade, PCFF, (world dollar price of coffee deflated by the dollar-price index of Kenyan imports) and on the terms of the International Coffee Agreement. The latter effect is captured through the use of an intercept dummy variable denoted as QUOTADUMMY:

$$XGCF = a_0 + a_1 YAGC + a_2 PCFF + a_3 QUOTADUMMY$$

$$XGCF = a_0 + a_1 YAGT$$

where YAGC and YAGT are the production levels of coffee and tea, respectively.

Oil exports are treated as exogenous. These exports are largely dependent upon external factors--specifically, the levels of economic activity in neighboring countries. Accordingly, we decided to treat this category of exports as outside the scope of the model.

Exports of commodities other than coffee, tea and oil --XGOT--depend on: foreign GNP, FGNP (the weighted average of the GNPs of Kenyas' principal trading partners); an average of current and lagged dollar prices of Kenyan commodity exports other than coffee, tea and oil relative to the average of the current and lagged CPIs of Kenya's principal trading partners (AVGPRICE); and the presence or absence of preferential trading relationships among Kenya, Tanzania and Uganda which ended with the breakup of the East African Community in 1977--represented by D7780.

$$XGOT = a_0 + a_1 FGNP + a_2 AVGPRICE + a_3 D7780$$

Services and Investment Income

Exports of services, XSOV, excluding factor income transactions, are assumed to depend on foreign GNP and on the dollar unit-value of Kenyan exports, PUX, relative to foreign consumer prices, FCPI. Imports of services, MSOV, excluding investment income payments, depend upon Kenyan real GDP, and the GDP deflator, PGDP, relative to the local currency cost of imports, PUM * EKL. Investment income payments, MSY, and receipts, XSY, are determined by the yield on US government bonds, USRML (a proxy for interest rates on Kenya's external debt), multiplied by long-term liabilities, FD + FL, and by the LIBOR rate multiplied by short-term external liabilities, FS. Hence, this approach distinguishes between long-term and short-term external debt liabilities:

$$XSOV = a_0 + a_1 FGDP + a_2 FCPI/PUX$$

$$MSOV = PUM (a_0 + a_1 GNP + a_2 [PGDP/EKL/PUM])$$

$$XSY = a_0 + a_1 USRML * (FD + FL) + a_2 LIBOR * FS$$

$$MSY = a_0 + a_1 USRML * (FD + FL) + a_2 LIBOR * FS$$

The relationship between investment income payments and net capital borrowings captures the effects on the economy of a change in foreign borrowings and deals with debt-servicing issues. Capital flows include private and government capital inflows as well as errors and omissions. Net foreign liabilities are derived via a cumulative process of combining net capital inflows over time. Net capital inflows including errors and omissions are taken as exogenous. Finally, the sum of balances on current and capital accounts yields the overall balance of payments, which affects Kenya's holdings of international reserves.

Simulation Results

In what follows, some multiplier properties of the Kenyan model are presented. In particular, the model was shocked in order to assess the impacts of changes in the following variables: real government expenditure, foreign real GNP, and the exchange-rate. The impacts are presented in terms of the deviations of key variables from the simulated baseline paths during the period 1976-1980. The baseline results are reported in Table 2.

Increase in Government Expenditure

Real government expenditure increases by ten percent in 1976, or roughly thirty million Kenya pounds in 1976 prices, and remains above its baseline level through 1980. The expenditure increase is assumed to be bond-financed. Nevertheless, monetary policy is accomodative due to the endogeneity of the money supply. The results of this experiment are provided in Table 3.

The fiscal stimulus creates additional demand for goods and services. Real GDP increases by about 53 million pounds and 59 million pounds, respectively, in the first and second years of the fiscal expansion. The government-expenditure multiplier reaches a peak of 1.9 in the second and third years of the fiscal stimulation but declines to a value of 1.0 in the fifth year. The effect of the rise in demand on inflation (as measured by the GDP deflator) is initially small but increases over the course of the simulation period as wage rates rise. During the fifth year of the simulation, the GDP deflator reaches a level three percent above its baseline value.

The fiscal expansion produces a fall in the dollar value of exports as higher costs of production lead to a decline in coffee and tea production. On the other hand, spurred by a higher real GDP and a higher domestic price

level, the dollar value of imports increases throughout the simulation period (reaching \$95.2 million in the fifth year). Consequently, both the trade account and the current account balances deteriorate at rapid rates.

Sustained One Percent Increase in Foreign GNP

Foreign real GNP is calculated as a weighted average of real GNP of Kenya's four major trading partners: the U.S., Germany, Japan, and the U.K. A sustained 1.0 percent increase in foreign real GNP increases real output in Kenya by .2 percent in the first year of the shock (Table 4). It reaches a maximum effect of .4 percent above the baseline in the third year of the shock, and is .3 percent higher in the fifth year. The reduced expansionary effect on real GDP during the final two years of this experiment is due to a decline in real fixed investment, resulting from a higher price level.

The growth in real output is induced via a rise in real exports of goods and services. The value of exports increases monotonically; in the fifth year of the simulation the value of exports is \$4.8 billion above its baseline value. However, the increase in domestic income, combined with a somewhat higher domestic price level, causes the value of imports to remain above its baseline value throughout the simulation period.

Sustained Ten Percent Depreciation in the Exchange Rate

A ten percent depreciation of the Kenya pound essentially makes domestically-produced goods less expensive abroad, production of export goods more remunerative and foreign goods dearer to the Kenyans. The effects of a ten percent depreciation of the pound are given in Table 5. Real exports increase as foreign demand rises and as domestic production of coffee and tea increases. However, the dollar-value of exports declines in the first year because of a J-curve effect, reflecting the inelastic overall demand for exports in the short-run. Nevertheless, since the foreign demand for Kenya's exports is more price-elastic in the medium-to-long run than in the short run, the depreciation leads to a rise in the dollar-value of exports over time. Through multiplier effects, the depreciation-induced increase in real exports causes real GDP to increase, initially by 85 million pounds, which is roughly 5.4 percent above the baseline value. Although GDP rises relative to the baseline, the dollar value of imports declines relative to the baseline, implying that the direct

effect of relative price changes on imports outweighs the induced income effects. Consequently, the improvement in the nominal trade balance rises from \$0.4 million in the first year to \$104 million in the fifth year as a result of the depreciation.

Policy Implications and Concluding Remarks

This paper has described the structure and properties of a large-scale macroeconometric model of the Kenyan economy. As noted at the outset, the major objective of our work has been to provide a model which can be used to assess --both quantitatively and consistently--the effects on the Kenyan economy of changes in major government policies, as well as of changes in external economic conditions. In addition to the simulation experiments presented in this paper, the model is capable of evaluating the impacts of changes in other domestic policies (e.g., monetary policy) and of external influences (e.g., changes in foreign interest rates).

The results of the simulation experiments confirm that, for this small open economy under a fixed exchange-rate regime, policy changes can have highly-significant and distinct effects on the macroeconomic situation. Fiscal expansion by itself runs up against well-defined limits. It has a pronounced positive effect on domestic output, but it also induces higher inflation and a marked deterioration in the trade and the current-account balances. The exchange rate devaluation similarly entails a powerful positive stimulus to domestic output even in a short run. However, it also produces a significant improvement on current account and in the overall balance of payments. The exchange-rate experiment generates inflationary impacts about equal in magnitude to those produced by the ten percent fiscal expansion, while it reduces the overall balance of payments deficit by about twelve to fifteen percent on average. Changes in foreign GNP have also been found to have significant impacts on Kenyan economic growth, prices, and the balance of payments, but, as the simulations indicate, exchange rate policy can be used to stimulate the economy and improve the balance of payments situation when external economic expansion is insufficient to accomplish these objectives. The model indicates the existence of trade-offs, and establishes a quantitative guide for real-world policy decisions.

Table 1: Prediction Statistics of the Kenya Model

<u>Variables</u>	<u>Mean Error</u>	<u>Root Mean Squared Errors (Percent)</u>
Real GNP	0.18	5.76
GDP Price Deflator	-1.91	4.79
Export Value (\$)	0.22	4.56
Import Value (\$)	-1.80	9.31
Export Price (\$)	-3.49	5.87
Import Price (\$)	-0.01	0.83
Coffee Exports	3.58	8.50
Coffee Export Price (\$)	-4.05	6.66
Tea Exports (\$)	6.10	12.48
Tea Export Price (\$)	-0.99	5.05

Table 2: Base Run

	<u>1976</u>	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>
Real Gross Domestic Product (Millions of 1976 Kenya Pounds)	1,579.9	1,656.5	1,686.1	1,892.9	2,043.1
GDP Deflator (1976=1.0)	0.94	1.13	1.17	1.19	1.25
Real Private Consumption Expenditure (Millions of 1976 Kenya Pounds)	981.2	1,054.3	1,099.1	1,210.9	1,299.2
Real Fixed Investment (Millions of 1976 Kenya Pounds)	332.2	338.3	379.9	409.4	379.1
Average Annual Wage Rate in Formal Sectors (Kenya Pounds per year)	405.4	459.7	493.8	546.9	613.0
Wage Employees in Formal Sectors (1,000 persons)	919.4	937.1	959.4	1,033.0	1,070.2
Money Supply (M1) (Millions of Kenya Pounds)	300.7	396.5	440.3	486.6	557.6
Bank Loans and Discounts (Millions of Kenya Pounds)	295.3	356.3	464.4	534.2	563.0
Current Account Balance (Millions of US Dollars)	-78.1	2.9	-373.0	-527.1	-755.6
Trade Balance (Millions of US Dollars)	-56.8	-38.0	-454.7	-722.9	-1,009.1
Merchandise Export Value (Millions of US Dollars)	818.6	1,121.6	942.1	976.6	1,331.5
Merchandise Import Value (Millions of US Dollars)	875.4	1,159.6	1,396.8	1,699.5	2,340.6
Exports of Coffee (Millions of US Dollars)	241.5	283.0	239.0	225.1	233.1
Exports of Tea (Millions of US Dollars)	78.8	98.9	101.9	106.5	109.1

Table 3: Sustained 10% Increase in Real Government Expenditure
(Deviation From Base Run)

	<u>1976</u>	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>
Real Gross Domestic Product (Millions of 1976 Kenya Pounds)	52.4	59.0	57.3	47.2	30.6
GDP Deflator (1976=1.0)	0.0004	0.005	0.010	0.018	0.035
Real Private Consumption Expenditure (Millions of 1976 Kenya Pounds)	23.2	28.5	33.6	34.7	31.7
Real Fixed Investment (Millions of 1976 Kenya Pounds)	14.5	18.4	19.1	17.7	9.3
Average Annual Wage Rate in Formal Sectors (Kenya Pounds per year)	3.3	5.9	10.0	14.3	17.2
Wage Employees in Formal Sectors (1,000 persons)	12.7	12.5	9.4	3.7	-1.7
Money Supply (M1) (Millions of Kenya Pounds)	4.5	11.3	19.1	26.8	28.8
Bank Loans and Discounts (Millions of Kenya Pounds)	13.3	27.6	40.6	54.2	54.2
Current Account Balance (Millions of US Dollars)	-39.2	-61.7	-81.8	-95.5	-105.6
Trade Balance (Millions of US Dollars)	-34.8	-56.1	-74.2	-89.3	-99.9
Merchandise Export Value (Millions of US Dollars)	0.9	-0.7	-0.9	-2.4	-4.7
Merchandise Import Value (Millions of US Dollars)	35.8	55.3	73.3	86.8	95.2
Exports of Coffee (Millions of US Dollars)	0.0	-0.3	-0.4	-0.7	-0.8
Exports of Tea (Millions of US Dollars)	0.0	-0.1	-0.1	-0.2	-0.3

Table 4: Sustained 1% Increase in Foreign Real GNP

	<u>1976</u>	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>
Real Gross Domestic Product (Millions of 1976 Kenya Pounds)	3.7	4.9	6.8	7.0	6.9
GDP Deflator (1976=1.0)	0.000	0.001	0.003	0.004	0.004
Real Private Consumption Expenditure (Millions of 1976 Kenya Pounds)	1.3	1.9	3.1	3.5	4.0
Real Fixed Investment (Millions of 1976 Kenya Pounds)	0.1	-0.8	-0.5	-1.2	-1.6
Average Annual Wage Rate in Formal Sectors (Kenya Pounds per year)	2.6	2.9	2.5	2.4	1.8
Wage Employees in Formal Sectors (1,000 persons)	8.9	8.9	8.6	8.8	7.6
Money Supply (M1) (Millions of Kenya Pounds)	0.1	0.2	0.2	0.2	0.7
Bank Loans and Discounts (Millions of Kenya Pounds)	0.6	2.5	2.5	3.8	5.2
Current Account Balance (Millions of US Dollars)	1.5	5.0	6.6	8.5	9.5
Trade Balance (Millions of US Dollars)	0.0	2.8	4.2	5.6	6.3
Merchandise Export Value (Millions of US Dollars)	1.7	3.1	3.3	3.4	4.8
Merchandise Import Value (Millions of US Dollars)	1.7	0.3	0.2	0.2	0.1
Exports of Coffee (Millions of US Dollars)	0.1	0.4	0.3	0.3	0.2
Exports of Tea (Millions of US Dollars)	0.0	0.1	0.1	0.1	0.1

Table 5: Sustained 10% Depreciation in Exchange Rate

	<u>1976</u>	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>
Real Gross Domestic Product (Millions of 1976 Kenya Pounds)	85.7	137.8	107.4	106.4	112.9
GDP Deflator (1976=1.0)	0.003	0.005	0.007	0.015	0.031
Real Private Consumption Expenditure (Millions of 1976 Kenya Pounds)	34.6	61.9	58.5	68.4	78.8
Real Fixed Investment (Millions of 1976 Kenya Pounds)	8.6	3.4	-8.9	-14.5	-13.7
Average Annual Wage Rate in Formal Sectors (Kenya Pounds per year)	2.3	7.3	13.2	23.3	34.5
Wage Employees in Formal Sectors (1,000 persons)	33.2	51.0	37.4	29.4	24.9
Money Supply (M1) (Millions of Kenya Pounds)	5.0	21.7	31.4	43.9	57.0
Bank Loans and Discounts (Millions of Kenya Pounds)	8.9	3.9	-1.1	-7.3	-12.3
Current Account Balance (Millions of US Dollars)	10.6	75.8	116.6	130.9	109.4
Trade Balance (Millions of US Dollars)	0.4	68.6	105.3	123.1	104.5
Merchandise Export Value (Millions of US Dollars)	-4.9	15.9	11.9	11.3	15.5
Merchandise Import Value (Millions of US Dollars)	-5.3	-52.7	-93.4	-111.8	-89.0
Exports of Coffee (Millions of US Dollars)	6.2	7.0	5.7	4.8	8.1
Exports of Tea (Millions of US Dollars)	1.4	1.7	1.7	1.6	1.3

SECTION SEVEN:
ECONOMISTS IN AID

James Mudge
Hadley Smith
Robert Muscat

THE ORIGIN AND FORMATION OF THE AID ECONOMISTS' CONFERENCE

by James Mudge.

Introduction

In 1979 several AID economists started discussing the changing demands on the Agency for economic analysis and the way AID used economists. The biggest perceived change was renewed interest in the economic policies of LDCs and related analysis. There also was an increasing awareness in the Agency that, routinely, economic analysis in project documents and in country strategy statements frequently was either not being done or was of poor quality. These trends were essentially recognized by the Administrator in a message to AID in 1981 when he emphasized the need for more and better economic analysis in Agency work. In response, a small group of economists sent a letter to the Administrator agreeing with his message and suggesting that to achieve an improvement in AID economic analysis performance it would be necessary to increase the number of economists in AID and institute some basic changes in the way the AID system employed economists to improve their productivity.

In 1981 AID started to recruit economists for the Foreign Service; the pace increased in 1982 and the effort continued at a somewhat diminished level into 1983. The result was the net addition of approximately 23 professional economists (about 30 new economists were actually hired). Coincidentally, in 1980, there was a major change in the hiring process when an Economists' Technical Panel, composed primarily of AID professional economists, was established to screen candidates. The systematic review of candidates by their professional peers substantially increased the weight placed on candidates' technical skills in the hiring decision process.

The idea of holding a conference of AID economists was one of several measures aimed at increasing productivity which emerged from the informal discussions. Other issues relating to the effectiveness of economists in AID were:

- Economists in AID tended to direct a disproportionately small amount of their time to economic work. AID could appreciably increase its economic analysis capacity by reallocating

economists' time away from general administrative duties and toward economic analysis activities.

- AID economic analysis capabilities could be substantially increased if AID economists were to attend refresher and other technical training courses. There was virtually no systematic communication among AID economists. Some communication was seen as a highly productive way to increase the professional capabilities of economists and increase their usefulness to AID. Communication could take several forms with periodic conferences being one option.
- Working as a professional economist in AID was not always compatible with the AID career system. Two major aspects of the problem were:
 - Almost everywhere in AID, but particularly in Missions, the priorities of supervisors differ from those of economists. Supervisors typically pursue objectives involving rapid preparation and movement of documents through the system. There is an inherent tension between these objectives and those of the AID economist who is likely to be concerned about the economic policy implications of actions and about evaluation of economic feasibilities.
 - There is limited opportunity for economists to be promoted to a senior level and continue to function as an economist. To climb the foreign service ladder it is necessary to change from the economics backstop to some other backstop, causing a relatively high attrition rate among the Agency's most experienced economists.

The preceding points summarize the informal group's thinking at the time. The points are a distillation of opinion and are essentially hypotheses. They are listed here to give a broader perspective to the thinking behind the AID Economists' Conference.

Although there was broad agreement in 1981 that a conference of economists would be useful, actual planning did not start until mid fall of 1983. Jim Mudge initiated the process with a draft agenda and a plan outline. (A meeting of economists and program officers for the LAC region was held in Washington in the fall of 1983.) A steering committee, comprised of economists from the

Regional offices, PPC and S&T, reviewed and refined the Conference draft agenda and plan in a series of meetings in late 1983 and early 1984. PPC/EA contacted the Pragma Corporation to handle Conference arrangements and logistical management. After some debate over convening a series of regional conferences versus one AID-wide conference, the committee decided to hold one, five-day meeting in the Washington area. This option seemed most appropriate given that economics and economists in AID were to be a major discussion topic. Cost effectiveness considerations dictated the five-day length and Washington area decisions. Proximity to Washington made it more simple to have guest speakers and the computer workshop.

It was logical that Mission economists be the main actors in the conference although implementing this principle was not easy, because the event was being initiated and coordinated from AID Washington. There was little precedent to draw on, and only limited time to communicate, prepare papers, etc. The steering committee decided to hold both small and large group meetings to encourage broad participation while still attempting to capture whatever consensus existed among the larger group of AID economists.

Before going further it is noted that the general topic of economics and economists in AID encompasses many important elements. Conceptually the elements can be divided into two groups: those pertaining to the demand for economic analysis in the Agency and those concerning the supply of the demand is also changing and in ways which are not always well understood, e.g., the implications of the shift in authority to review and approve projects from AID/W to the field; the greater emphasis on non-project assistance; the interaction of stabilization and structural adjustment programs with AID country programs; and the real versus the nominal requirements in AID for systematic economic analysis. In a general sense the material in many of the papers in this Report address the demand side. Thus, the following discussion concentrates on the supply side, i.e., on economists in AID and issues relative to their productivity.

Systematic Change

the professional versus the expert
the urgent versus the important
the manager of analysis versus the analyst
the generalist versus the specialist (economist)

Most economists understood when they joined AID that they would not be engaged in a heavy schedule of theoretical work or basic economic research. It was understood that the economic work in AID is applied.

It is also understood that most AID economists are Foreign Service Officers and that they work in circumstances which demand that, like their FSO colleagues, they must be ready and willing to do many tasks. Thus, when reference is made to the AID economist working as an economist, it is a relative statement meaning the majority of the time the economist spends his/her working effort on technical economics, but that the economist also performs other tasks and that the economist is knowledgeable and conversant on a broad range of AID activities and procedures.

The following discussion is concerned with what AID economists do--economic work or other. Economics "work" or "analysis" in this context is applied economics in the sense that the analysis is expected to be of direct benefit or concern to AID. (Note however that the techniques used should be well grounded in theory and may be relatively sophisticated. This may prompt some non-economists to accuse the economist of being "too theoretical.")

This discussion explores the hypothesis that demands on AID economists to do administrative and managerial work, frequently for reasons beyond any single individual's control, routinely result in the erosion of analytic skills to the detriment of the Agency. That is, the present system tends to constrain the flow of economic analysis and, in the process, to diminish the institution's stock of economic analysis capability. Greater concentration of economists' time on applied economic analysis would tend to increase both the flow of economic analysis and the Agency's stock of economic expertise.

There are some 300 professionals in AID who have degrees in economics. An even larger number of individuals are involved on a day-to-day basis in economic issues and may be quite articulate in using economic terms in discussions. Their term "AID economist," however, refers to a person trained in economics and encumbering an economist's slot. The AID economist is the career person responsible for providing AID with professional-caliber economic analysis and economic judgement. The discussion pertains to the AID economist.

The problem of improving the productivity of AID economists is more difficult to address than the problem of

increasing numbers. Many AID economists agree that they ought to do more economics and less general administrative work. Responses to a simple survey questionnaire, distributed at the Economists' Conference, indicate that AID economists "guesstimate" that they spend an average of 61 percent of their total time on economics of which an average of 25 percent goes to analytic work, 33 percent to economic reporting and 43 percent to other economics related activities. If we treat analyses and reporting as core activities, AID economists are engaged in economics work for about one-third of their time.

It is not a simple matter to shift AID economists' efforts away from other tasks into economics because the economist's time may be more valuable to the managing unit when used to manage or administer. That is, AID economists might agree that they should allocate more time to technical economic work, but the system and their immediate supervisors may not share this sentiment. Furthermore, it is probably true that all technical specialists in AID--engineers, anthropologists, sociologists--experience the same kind of diversion from their discipline, so why should economists be given special consideration? This is the wrong question. If other specialists find themselves in a similar situation and see similar disadvantages, then they should start asking how they, as specialists, can best serve the Agency.

In response to why "the system" should be interested in the AID economist concentrating more on economics, the reason is that, as the economist devotes more time to non-economic tasks, several things happen which are not in the best interest of AID. Exactly what occurs is a function of the individual economist, the management unit and its particular circumstances. But general observation and conversations with AID economists suggests that typically, over time, the economist is expected to do more non-economic work or quasi-economic work and less of the core economics tasks. Thus, for example, when some economic analysis must be done that will require several days of effort, there is a strong likelihood that a consultant will be brought in while the AID economist who is "too busy" takes care of the administrative aspects of the consultant's visit. The economist thereby becomes a consumer, but not a producer of economic analysis.

Having the economist work as a generalist is convenient for the management unit but there are opportunity costs to AID because the Agency is not exploiting the powerful potential of an individual who has the combination of

several years of intensive training; residence in a country where he/she has numerous contacts; and access to information. This does not mean that economist should be squirreled away in a corner conducting some abstract analysis. The AID economist is in a prime position to see or to find and explain economic trends or relationships or other underlying factors affecting programs and projects that his/her non-specialist colleagues are not equipped to discover.

A related problem is misdirection of economists' efforts. Typically, in AID, many of the questions and issues which economists work on are not developed by economists. Many of these problems are significant and warrant investigation (which is frequently done by contractors), but many are the wrong questions. That is, they are not the correct ones for getting at important policy issues. The AID economist, if allowed to concentrate more on applications of his/her discipline, can be expected to improve this.

There is a dynamic aspect to the time allocation problem in addition to the static efficiency considerations. As the economist devotes less effort to economic analysis over time, he/she is more likely to become reluctant to undertake analysis when the need arises. There is no way of telling with precision how widespread this kind of reluctance is among AID economists, but there can be little doubt it exists. Thus, there is the real risk of the AID system fostering growth in the number of economists who are increasingly less active in their discipline, and therefore increasingly unable and unwilling to conduct analysis. The result is the gradual erosion of in-house technical capability such that real analytic capability diminishes relative to the nominal level (as indicated by the number of economists). The ultimate result is that top-level decision makers gradually receive less of the critical information they need for well-informed decision making.

The management of AID economists may be viewed as a kind of unstable equilibrium problem in which the system either functions so economists' analytic skills are relatively fullutilized, and thereby maintained and improved over time (also permitting more effective adaptation to new demands) or their skills are allowed to stagnate with consequent declines in quality and ability to adapt. If there is a problem, it is up to AID economists to identify it, understand it and suggest solutions.

ECONOMISTS AND MISSION MANAGEMENT

By Hadley Smith

Introduction

My remarks are directed toward the effectiveness of economists in getting their messages across to mission and Agency management and implemented in the development programs of the Agency and host countries. Although the process works more or less smoothly, observations focus on the trouble spots. The obstacles are numerous, including the non-economic academic background of the majority of both mission and Agency managers, the desire of administrators to achieve other objectives, rather than optimizing or maximizing impact on development policies, mission directors with little development experience in the field, conflicting policy precepts in AID strategy and legislation, the decreasing staff available to most missions in Africa, and the limited professional support to mission economists, such as a staff of local economists, office facilities, and research assistance.

Perhaps the most frustrating problems are the occasions when mission management is reluctant to accept economic generalizations which are widely accepted throughout the development community. Management views may be contrary to the conclusions of IBRD and IMF as well as the mission economist. The idea that import substitution, for example, is equal in usefulness and importance, or preferable, to production of exports, may be so deeply ingrained that the economist is unable to dislodge this policy conclusion in the mission CIP and development assistance strategy. AID conventional wisdom of the 1960's and 1970's must be reassessed in many African countries. Without the understanding and support of the mission director for generally accepted macroeconomic principles, narrower sectoral views prevail in mission decision on program issues.

Conflicting policy directives in AID legislation and guidance may also preempt macroeconomic objectives. AID's commitment to support of the small farmer, for example, or to production of food crops as higher in priority than cash crops, can be interpreted in a way which restricts giving higher priority to investment to increase the near-term capacity of the economy to earn foreign exchange. The fact

that mission and Agency managers and economist have different professional backgrounds is part of the explanation for differences in weighting of priorities of economic problems and policies among AID staff. As a result, the urgency of supporting agricultural credit institutions with local currency and imported agricultural inputs for exports, for example, may be lower in the mind of the director than other activities with less impact on production and exports. Mission management also may not be willing to tackle macroeconomic issues seriously even though they are recognized as urgent by the consultative group of donors, on grounds that resistance within the host government would negate the effectiveness of the effort. Urging by economists of rigorous quantitative assessment of the net foreign exchange benefits from CIP programs may not result in responsive evaluations.

Administrative discretion in selecting the economist and in directing his work also can influence negatively the effectiveness of economic policy decisions. Economist may have specialization in fiscal policy, monetary policy, international trade, agriculture, quantitative analysis, business, or other aspects of the discipline. In some cases, mission management may not distinguish meaningfully among the skills, aptitudes, and other qualifications of different economists. If mission management chooses to emphasize a traditional AID program, macroeconomic responsibilities may assigned to a sectoral economist. The result is likely to be underemphasis on the exchange rate, the capacity to earn foreign exchange, and other macroeconomic issues. At the same time, mission management may be more concerned with the economist's skill in conducting benefit/cost analysis of projects than with the ability to help give macroeconomic direction to the mission program. Wise use of the mission economist probably permits rather limited time for economic analysis in designing projects, particularly in specialized types of analysis such as highway and other transport projects. Nevertheless, participation in the conceptual design and review of projects is or should be a major role of the economist.

Tensions within a mission are likely to be greatest in countries where the policy structure and economic performance are poor and where U.S. political objectives tend to override rigorous pursuit of policy reform objectives. Vigorous policy leadership is needed from AID but reticence, and deference to the IBRD and IMF are normal. In such cases, traditional sectoral AID programs with limited macroeconomic perspective and impact are likely to remain largely unchallenged.

Administrative decisions in managing the work of the economist also can subordinate his or her input to other mission staff, such as the project officer or program officer, who then are in a position to modify the conclusions of the economist in preparation of documents such as the CDSS and PAAD. Without a mission director who understands and is genuinely concerned and courageous about economic policy issues, the views of the economist can be lost or diffused.

Suggestions for Strengthening the Role of Economists.

Professional input by leading American economist from outside AID could help substantially in broadening the scope of macroeconomic discussions in missions and reinforcing the role of the mission economist. To be effective, this should be a major input involving several weeks of effort culminating in analytical reports with policy recommendations for review by both the mission and the host government. Funding probably is easiest under CIP programs, where these exist, but could be financed by AID/W, or mission projects.

In cases where the position of the economist is isolated within the mission, good communication between the economist and professional backstop in AID/W is particularly desirable and the involvement of AID/W economists should be expected. Economists in AID/W need to be clearly aware of their backstop responsibility in supporting economic principles, particularly those raised by mission economists in PID, PP, PAAD, and CDSS reviews. In many African posts, where telephone communication with Washington is restricted at best, mission economist often have not been able to draw on support of professional compatriotes in AID/W.

In the administration of regional bureaus, more effort should be made to assign economists to deputy and mission director and OAR positions. Programs are unlikely to have the kind of macroeconomic perspective that is needed if top managers do not have the professional background and experience for dealing with these issues. In Washington, economists are needed in senior positions. AID, in recent years, has tended to select implementing skills, such as controllers, project officer, and engineers, for top positions which influences the perception of policy formulation and the way in which regional bureaus carry out responsibilities.

THE ROLE OF THE ECONOMIST IN AID

by Robert Muscat

Looking back over the discussion and papers on the subject of the role of the AID economist, and the many times in the sessions on each of the substantive topics that the question of the function of the economists arose, it is clear that the question of roles goes beyond what a non-economist observer might have concluded was a meeting devoted to parochial complaints over benign neglect. The almost universal complaint over mission and Agency treatment of economic analysis in project design is legitimate; AID requires such analyses and allocates economist staff time to preparing them, but the analyses play little part in the process of project choice among alternatives. But the cynicism over use of economic analysis in program planning at the CDSS level of program strategy, the sector level of problem analysis and identification of project alternatives, reflects more than just inadequate use of staff capabilities.

This latter neglect speaks to the non-economic dynamics of bilateral aid. An observer whose memory stretches back to much earlier days of development assistance might see a striking contrast between the reality of the relative size, influence and role of AID (and predecessor agencies) "back then"--when other donor aid was quite small, the volume of many country programs was much more significant in relation to host country development budgets, and host governments (and local university economics faculties) had few economists (or other development policy disciplines) with advanced training or experience--and the situation today. It is true that AID policy dialogue has many creditable recent examples of sector-level negotiation based on sound ideas backed with good analysis. But the idea (which seems implicit in AID's elaborate instructions) of doing a kind of shadow planning commission job in the CDSS, as the basis for scanning the entire array of potential involvement and then deciding the allocation of very minor resource inputs, seems disproportionate if not pretentious. The handbooks still reflect the scale of AID's work in the past in many large programs. In addition, many other agencies are engaged in technical assistance at the macro and sectoral level, especially the IFIs and some UN agencies; few (perhaps no) other donors operating at levels comparable to AID's require such elaborate framework analysis.

Whatever the upshot of such considerations ought to be, one thing is clear from this conference. The economists agree that the Agency is not making optimal use of economic analysis. Several recommendations were developed to deal with this problem, including some ideas on economists' organization within the agency, and new formal arrangements in Washington and in field missions that would bring greater focus and relevance to the work of the Agency's economists. One economist stressed the importance of the informal relationship between the economist and the field mission management, and the responsibility of the economist to put the results of his/her work (especially respecting the measurement of economic merits of proposed activities) into senior management decision-making. The key to effective communication is for the economist to recognize the extent of economics literacy in the front office, and fashion for himself a role as conceptualizer based on the analytic tools and insights of the science.

APPENDICES

Richard Collins

Ben Severn

Participant List

Conference Agenda

Scopes of Work

Survey of AID Economists

Conference Evaluation Survey

AID'S ECONOMIC AND SOCIAL DATABASE

by Richard Collins

The Center for Development Information and Evaluation maintains a database from the following sources:

International Monetary Fund

- International Financial Statistics
- Government Financial Statistics
- Balance of Payments
- Direction of Trade

World Bank

- World Tables
- Debt
- Social Indicators
- National Accounts

United Nations

- National Accounts
- Energy
- Trade by Commodity
- 1982 Assessment of Population Growth to 2025

US Department of Agriculture

- Food Aid Needs and Availabilities
- Production Indices
- Foreign Agricultural Statistics
- Grains Report

Other Organizations

- Inter-American Development Bank
- US Department of State
- US Department of Defense
- Pan American Health Organization
- International Labor Organization
- Organization for Economic Cooperation and Development
- World Health Organization
- Food and Agricultural Organization

Approximate Size of the Database

November 1984	1400 time series per country, 1960-1982
March 1985	2500 time series per country, 1960-1983

Why would you want macro data?

In preparing for a country policy dialogue it is necessary to have a clear picture of the development needs of the country, to understand the state of the economy and its sensitivities to internal and external perturbations, and to have as complete a picture as possible of the social and cultural structure of the country. The purpose of the Economic and Social Database is to provide the data on which to base models of the economy, social and cultural patterns, and development needs. These models are intended to give historical, current and future views of these facets of the country.

Does the Economic and Social Database have subnational data?

No. Our feeling has been that data which is only available for one country should stay in that country. Data available for a region should stay in the region, and only data which is available for all countries will be kept in the ESDB. This means that we encourage countries and missions to develop an independent capability for storing and analysing data specific for the needs of the country. We are very willing to help missions and ministries to set up databases and analytical tools for planning and monitoring of country economic and societal variables.

In what form does the data exist and how can I get it?

The time series are maintained in Statistical Analysis System (SAS) datasets on AID's mainframe in Washington. They can be requested from PPC/CDIE in any of the following forms:

1. IBM Standard Labeled 9-track tape
2. Unlabeled 9-track tape
3. IBM PC, MS-DOS ASCII files for use with:
 - a. Lotus
 - b. SL-Micro
 - c. TSP
 - d. GAMS
 - e. Micro-Stat
 - f. D-base II, III
4. Wang PC, MS-DOS ASCII files for use with:
 - a. Lotus
 - b. D-base II
5. Wang VS 100 formatted tapes
6. Other, if we have access to necessary equipment

What does CDIE get out of it?

The Center encourages analytic approaches to planning and evaluation. If you develop an application which you feel would be useful for other countries, send it to CDIE.

TRAINING AND CAREER DEVELOPMENT PROGRAMS
FOR PROGRAM ECONOMISTS*

by Ben Severn

Note

A written proposal was presented at the Conference which outlined a plan for establishing a training program for AID economists. A questionnaire was attached to the proposal which asked the respondent to agree or disagree with the proposal and to provide suggestions for its content. The respondent was also asked to vote on a working group list. Space was provided for suggest alternatives.

There were eighty-three responses, with eight-two agreeing with the proposal and giving authority to a working group chairman for the effort. Several names for the working group were suggested by the respondents.

The proposal also included a general scope of work for the working group as well as an action plan. As the attached copy of the proposal indicates, it was anticipated that significant action would be taken by August 1, 1985. For a host of reasons, that has not occurred. However, the effort has begun anew. Ben Severn will be working on a plan in the fall of 1985. The plan is to provide AID economists with a substantial progress statement by late 1985. Barring interruptions like those encountered this past year, a plan, with course outlines should be in-hand by late May, 1986.

Statement of Problem

1. The lack of organized training and career development programs for the Program Economist has become an important concern for many who have been with the Agency for a few years and who would like to consider staying for their entire career.

2. No one office seems to be charged with worrying about us.

* And related brethren
Plan presented to the Conference, November 1984.

3. It is clear that we will have to initiate the action.

4. We must develop a plan of action complete with curriculum, alternative modes of presentation, and costs associated with the program. We must present it to management, presumably directly to the Administrator.

5. To begin the process we need to obtain a sense of the group's needs by having each of you respond to the relevant questions found in the general questionnaire and to complete page three of this handout.

6. With your cooperation we should be able to tabulate most of the results before the end of the conference, and identify the Working Group charged to begin the process.

Action:

1. Page two lays out a suggested general scope of work for the Working Group and an estimated time table for arriving at the moment development of the courses will begin.

2. Page three provides the opportunity to respond to the concept presented here, to judge the suggested working group, and to make any comments you deem relevant.

Actions to be taken

A. Stage One - 60 days starting from January 1, 1985

1. The working group will break down the Program economist's job into specific task sets.

2. Using the specific task sets and responses to the questionnaire as a guide, the working group will select topics to be included in the curriculum for upgrading and maintaining basic skills. With assistance from the Training Office, a series of management courses designed to prepare the Program Economist for assuming management roles will also be developed.

3. The working group will consider different alternative modes for presenting the materials, e.g. seminars or courses in AID/W, and video tapes with manuals and traditional correspondence course presentations for use at missions.

4. The working group will provide cost estimates for each alternative and will provide several course schedule sequences with any extra costs identified.

B. Stage Two - 30 days

This first draft will be given to all Program Economists. Three weeks will be given for response time.

C. Third Stage - 45 days

Comments from the Program Economists (and others as appropriate) will be incorporated into a second draft which also will be shared with all Program Economists. A three week response period from the field will be set.

D. Fourth Stage - 45 days

A final draft will then be prepared and presented to AID/W management, presumably directly to the Administrator.

E. Fifth Stage - 30 days

Distribution of Management's response.

F. Final Stage - the beginning, about August 1, 1985

Response to the Proposal to Create a Working Group
For the Purpose of Establishing a Training and Career
Development Program for Program Economists

1. Agree _____, disagree _____ with the proposal.
2. If you checked the disagree choice, are there some changes that might make the proposal acceptable?
Yes _____ No _____

If yes, what are they?

3. For the working group we would suggest two representatives from each regional bureau, two from PPC, and one at large, for a total of 11 members. We would suggest the following names:

<u>LAC</u> :	Jim Fox Ben Severn	<u>Africa</u> :	Jerry Wolgin Larry Saiers
<u>NE</u> :	Ed Krowitz Len Rosenberg	<u>Asia</u> :	Mike Crosswell Curt Wolters

At Large: Mike Farbman

4. Are the above names acceptable? Yes _____ No _____
5. Changes or additions you would like to see in the list:

Name (optional)

AID ECONOMISTS' CONFERENCE

Participant List

Robert Adler
USAID/San Jose

Nishkam Agarwal
USAID/Dhaka

Richmond Allen
USAID/Amman

Dave Alverson
USAID/Manila

Ms. Supanee Artachinda
USAID/Bangkok

Peter Askin
LAC/CEN

Ed Auchter
FVA/PPE

Ravi Aulakh
USAID/Khartoum

Luis de Azcarate
IBRD

Alan Batchelder
PPC/EA

Ken Beasley
LAC/DP

H. Clay Black
USAID/Dakar

Bonni van Blarcom
S&T/AGR

Don Bowles
PPC/CDIE/PPE

Marshall Brown
AA/LAC

Scaff Brown
LAC/DR

Robert Burke
USAID/Lima

Juan Buttari
PPC/PDPR/EPD

C. Stuart Callison
REDSO/EA

David Carr
USAID/Cairo

Maggie Chadwick
Pragma

John Chang
USAID/Santa Domingo

Phil Church
S&T/AGR

Edward Clarke
PPC/PDPR/EPD

Collette Claude
AFR/DP

Neal Cohen
USAID/Swaziland

Jennifer Collins
PPC/EA

Richard Collins
PPC/E

Ed Costello
USAID/Monrovia

Gray Cowan
PPC/PDPR

Michael Crosswell
ASIA/DP

Paul Crowe
USAID/Cairo

Ralph W. Cummings
S&T/FA

Larry Dash
LAC/DP

Rene R. Daugherty
REDSO/EA

Harlan Davis
S&T/AG

Peter Davis
USAID/Manila

Jacques Defay
Pragma

Michael Di Legge
FVA/FFP

Joseph DeSousa
FM/LMD

Paul Deuster
PPC/EA

Harold Dickherber
USAID/Tunis

John A. Dixon
East West Center, Hawaii

David Dod
USAID/Cairo

John Doggett
Doggett and Associates

Vic Duarte
NE/E

Forest Duncan
FVA/FFP

Mark Edelman
AA/AFR

Jim Elliot
AFR/DP/PAR

Gene Ellis
Denver, Colorado

John Eriksson
DAA/S&T

Shirley A. Erves
AFR/DP

Mike Farbman
S&T/RD/ESE

Vernita Fort
AFR/DP

Jim Fox
LAC/DP

Michael Fuchs-Carsch
USAID/Rwanda

Mark Gallagher
AFR/DP

Hans Gerhard
IMF

Bill Gardner

Roger Garner
AFR/PD/CCWAP

William Gelabert
M/PM/AD/TD

Mark Gellerson
NE/TECH/SARD

Michael Gomez
Interamerican Development
Bank

Richard Greene
USAID/Nairobi

Roy Grohs
NE/DP/PL

Richard P. Harber, Jr.
AFR/DP/PAR

Arnold Harberger
University of Chicago

Jessie Hartline
USAID/Panama

Allison Herrick
DAA/PPC

Julian Heriot
USAID/Guatemala
ROCAP/ESA

Nadine Hornstein
PPC/WID

Galen Hull
Pragma

Mark Kraczkiewicz
NE/DP/PL

Jerome La Pittus
USAID/Tegucigalpa

Maureen Lewis
PPC/PDPR/EPD

Joseph Lieberman
PPC/DC

Harold Lubell
USAID/Cairo

Nicolaas Luykx
S&T/N

Roberta Mahoney
AFR/DP

Jerre Manarolla
NE/DP/PL

Fred Mann
USAID/Lima

Robert Maushammer
USAID/Lima

Josette Maxwell
PPC/PDPR/EPD

Don McClelland
PPC/PDPR/EPD

Alexander Meeraus
IBRD

Jose Mendez
AFR/DP

Louis De Merode
USAID/Bamako

Duncan Miller
REDSO/WCA

Tom Miller
PPC/PDPR/EPD

Russ Misheloff
NE/MEUR

Roger Montgomery
USAID/Dhaka

Paul Morris
USAID/Kathmandu

Dennis Morrisey
NE/E

Jim Mudge
PPC/EA

Paul Mulligan
USAID/Islamabad

Robert Muscat
McLean, Virginia

Paul O'Farell
PPC/PDPR

Mary Ott
LAC/DR

Carol Pearson
Pragma

Robin Phillips
USAID/Bridgetown

Edward J. Ploch
USAID/Bangkok

Patricia Rader
FVA/PPE

Charles Richter
PPC/PDPR

Warrior Richardson
PPC/EA

Neal Riden
PPC/EA

Leonard Rosenberg
NE/DP/PL

Lee Ann Ross
USAID/Colombo

Robert Rucker
USAID/Jakarta

William Ruotola
SER/IRM

Minor Sagot
USAID/San Jose

Larry Saiers
AFR/DP

Fenton Sands
USAID/Kampala

David Schroder
NE/TEC/AD
6484 N.S.

Meredith Scovill
AFR/DP

Ben Severn
LAC/DR

Samuel L. Skogstad
USAID/Kingston

Jack Sleeper
USAID/Cairo

Hadley F. Smith
REDSO/WA

James T. Smith
USAID/Rabat

James G. Snell
USAID/Lusaka

Ray Solem
PPC/CDIE/PPE

Edward Stanley
USAID/Monrovia

Craig Steffenson
ASIA/EA

Carol Stengel
ASIA/PD/EA

Kenneth Swanberg
S&T/RD/RI

Szabolcs Szekeres
I.I.D.

F.Wayne Tate
US Advisor/ADB

Peter Thormann
USAID/New Delhi

Kiertisak Toh
USAID/Niamey

Henrietta Towsley
PPC/PDPR/EPD

Tham V. Truong
USAID/Ouagadougou

Mike Unger
PPC/EA

Jan van der Veen
USAID/Dhaka

James Walker
USAID/Port au Prince

Tom Ward
M/PM/FSP/CDE

John Westley
ASIA/DP

Fred E. Winch
USAID/Khartoum

Fred Witthans
USAID/Mogadishu

Jerry Wolgin
AFR/DP

Curt Wolters
ASIA/DP

Theodora Wood-Stervinou
REDSO/WCA

Robert Young
S&T/RD

Clarence Zuvekas
LAC/DP

AGENDA FOR CONFERENCE OF A.I.D. ECONOMISTS

SUNDAY, NOVEMBER 4

- 4:00 PM Buses leave 21st Street entrance of State Department
- 6:30 PM Cocktails (cash bar)
- 7:15 PM Dinner . . . followed by
Opening Remarks by Kenneth Kauffman, PPC/EA
Address by Frank Kimball, Counselor to the Agency

MONDAY, NOVEMBER 5

- 9:00 AM An Outline of Conference Procedure,
Kenneth Kauffman, PPC/EA
- 9:15 AM Economic Stabilization, Structural Adjustment,
and Long Term Development: Implications for AID
Programs
- Mike Crosswell, ASIA/DP, Moderator
Roy Grohs, NE/DP, Rapporteur
Hans Gerhard, IMF
Luis de Azcarate, IBRD
Clarence Zuvekas, LA/DP
Jerome LaPittus, Honduras
- 10:45 AM BREAK
- 11:00 AM Economic Stabilization, Structural Adjustment,
and Long Term Development: Implications for
AID Programs (cont.)
- 12:00 PM LUNCH
- 1:30 PM Policy Dialogue: A Series of Four Simultaneous
Panels
- PANEL A
Jim Mudge, PPC/EA, Moderator
Robin Phillips, Bridgetown, Rapporteur
Shirley Erves, AFR/DP
Judd Heriot, ROCAP
Richard Greene, Kenya
Sam Skogstad, Jamaica

MONDAY, NOVEMBER 5 (continued)

PANEL B

Larry Saiers, AFR/DP, Moderator
Don McClelland, PPC/PDPR, Rapporteur
David Dod, Egypt
Peter Davis, Philippines
Fred Winch, Sudan
Robert Adler, Costa Rica

PANEL C

Mike Farbman, S&T, Moderator
Roberta Mahoney, AFR/DP, Rapporteur
Kiart Toh, Niger
Jay Smith, Morocco
Robert Rucker, Indonesia
Juan Belt, Panama
Stu Callison, REDSO/EA

PANEL D

Jim Fox, LA/DP, Moderator
Frank Martin, Sudan, Rapporteur
Louis de Merode, Mali
Jan van der Veen, Bangladesh
Paul Mulligan, Pakistan
Jerome LaPittus, Honduras

3:30 PM

BREAK

3:45 PM

Policy Dialogue: A Series of Four Simultaneous
panels (cont.)

5:00 PM

DINNER

7:30 PM

A Survey of Recent Trends and Issues in
Economic Development and Development Economics

Arnold Harberger, University of Chicago

TUESDAY, NOVEMBER 6

9:00 AM

Policy Dialogue: A Plenary Session to
Synthesize and Distill AID's Experience

Kenneth Kauffman, PPC/EA, Moderator
Colette Claude, AFR/DP, Rapporteur
Jim Mudge, PPC/EA
Larry Saiers, AFR/DP
Mike Farbman, S&T
Jim Fox, LAC/DP

TUESDAY, NOVEMBER 6 (continued)

- 10:45 AM BREAK
- 11:00 AM Policy Dialogue: A Plenary Session to
Synthesize and Distill AID's Experience (cont.)
- 12:00 PM LUNCH
- 1:30 PM The Use of Economic Analysis in the Forming of
Country Development Strategies
- Stu Callison, REDSO/E, Moderator
Larry Dash, LAC/DP, Rapporteur
Jerry Wolgin, AFR/DP
Paul Mulligan, Pakistan
Sam Skogstad, Jamaica
- 3:15 PM BREAK
- 3:30 PM Country Economic Models: Are They/Can They be
Useful for AID Purposes?
- Jim Elliott, AFR/DP, Moderator
Tham Troung, Burkino Faso, Rapporteur
Yoon Lee, AFR/DP
George Tavlas, State
Neal Cohen, Swaziland
Mike Crosswell, ASIA/DP
- 5:00 PM Micro-Computers: Software, Hardware, Data-sets:
A Tour d'Horizon
- Catherine Gleason, SER/IRM
- 6:00 PM DINNER
- 7:30 PM MICROCOMPUTER WORKSHOPS

SESSION A

Sensitivity Analysis Jack Sleeper, Egypt
Project Analysis Gene Ellis, U. of Denver

SESSION B

Regression
Analysis--TSP Jim Elliot, AFR/DP
Swaziland Model Neal Cohen, Swaziland
Balance of Payments
Template Rick Harber, AFR/DP

WEDNESDAY, NOVEMBER 7

9:00 AM Project Economic Analysis: A Series of Four
Simultaneous Panels

PANEL A

Juan Buttari, PPC/PDPR, Moderator
Mary Ott, LA/DR, Rapporteur
Jim Walker, Haiti
Paul Crowe, Egypt
Lee Ann Ross, Sri Lanka

PANEL B

Ben Severn, LAC/DR, Moderator
Theodora Stervinou-Wood, REDSO/W, Rapporteur
Roger Montgomery, Bangladesh
Maureen Lewis, PPC/PDPR
Jack Sleeper, Egypt

PANEL C

Len Rosenberg, NE/DP, Moderator
Mark Gallagher, AFR/DP, Rapporteur
Nishkam Agarwal, Bangladesh
Duncan Miller, REDSO/W
Alberto Ruiz de Gamboa, PPC/PDPR

PANEL D

Jan van der Veen, Bangladesh, Moderator
Paul Deuster, PPC/EA Rapporteur
Paul Morris, Nepal
Fred Witthans, Somalia
Mark Krackiewicz, NE/DP

10:45 AM BREAK

11:00 AM Plenary Session: Improving Economic Analysis
of Projects: Synthesizing the Panel
Discussions

Paul O'Farrell, PPC/PDPR, Moderator
Josette Maxwell, PPC/PDPR, Rapporteur
Juan Buttari, PPC/PDPR
Ben Severn, LAC/DR
Len Rosenberg, NE/DP
Jan van der Veen, Bangladesh

WEDNESDAY, NOVEMBER 7 (continued)

- 12:00 PM LUNCH--There will be three separate rooms in which papers will be presented.
- 1:30 PM Economics of Private Enterprise Development
Ed Clarke, PPC/PDPR, Moderator
Discussants:
Robert Muscat, Consultant
Maureen Lewis, PPC/PDPR
Harold Lubell, Egypt
- 3:00 PM BREAK
- 3:15 PM Economics of Training Projects
Ben Severn, LAC/DR, Moderator
Discussants:
Mike Gomez, IDB
Frank Method, PPC/PDPR
Bob Young, S&T/RD
- 4:30 PM Economics of Technology Development
John Eriksson, S&T, Chair
Discussants:
Tom Ledderer, PPC
Peter Thormann, India
Scraff Brown, LAC/DR
Harlan Davis, S&T/AG
- 5:45 PM DINNER
- 7:30 PM MICROCOMPUTER WORKSHOPS
SESSION A
Risk Calculation in Project Economic Analysis:
Szabolcs Szekeris, IID
SESSION B
SL Micro: Statistics on the Micro
Catherine Gleason and James Feaster
- 7:30 PM Economic Analysis: Natural Systems and the Environment, presented by John Dixon, East-West Environmental and Policy Institute

THURSDAY, NOVEMBER 8

9:00 AM Economists in AID: Four Panels on the Economist and Top Management: Participants to include Both Economists and Senior AID Managers

PANEL A

Larry Saiers, AFR/DP, Moderator/Rapporteur
John Eriksson, DAA/S&T
Philip Birnbaum, DAA/AFR
Hadley Smith, Sudan
Ed Krowitz, NE/E

PANEL B

Jim Fox, LAC/DP, Moderator/Rapporteur
Fred Witthans, Somalia
Cam Wickham, El Salvador
Marshall Brown, DAA/LAC

PANEL C

Dennis Morrisey, NE/DP, Moderator/Rapporteur
John Westley, Asia/DP
Hariadene Johnson, AFR/DP
Bob Burke, Peru
Peter Davis, Philippines

PANEL D

Mike Crosswell, ASIA/DP, Moderator/Rapporteur
Peter Askin, LAC
Allison Herrick, DAA/PPC
Jay Smith, Morocco
Jerry Wolgin, AFR/DP

10:30 AM BREAK

10:45 AM Training for AID Economists: What is Available and What is Needed?

Ben Severn, LAC/DR, Chairman
William Gelabert, M/PM/AD/TD

12:00 PM LUNCH

1:30 PM Economists in AID: A Plenary Session on Personnel Issues Such as Career Ladders, the Open Assignment System, New Hiring Policies

Kenneth Kauffman, PPE/EA, Moderator
Panelists:
William Granger, M/PM/R
Tom Ward, M/PM/FSP/CDE

THURSDAY, NOVEMBER 8 (continued)

3:00 PM BREAK
3:15 PM REGIONAL MEETINGS
6:00 PM DINNER
7:30 PM MICROCOMPUTER WORKSHOPS

SESSION A

Using Lotus in Ag. Project Analysis
Bonni van Blarcom, S&T/AGR
Developing Macros in Lotus
Rick Harber, AFR/DP

SESSION B

Economic Data Available in the AID Computer
System and How You Get It
Richard Collins

GAMS and CGE Modeling Programs
Alex Meeraus, World Bank

Economic Analysis: Natural Systems and the
Environment
Presented by John Dixon, East-West
Environmental and Policy Institute (a repeat of
the Wednesday evening session)

FRIDAY, NOVEMBER 9

9:00 AM REGIONAL MEETINGS

11:00 AM BREAK

11:30 AM LUNCH followed by Plenary Session to Summarize
the Conference

Clark Joel, Moderator
Mike Fuchs-Carsh, Rwanda, Rapporteur
Larry Saiers, AFR/DP
Mike Crosswell, ASIA/DP
Jim Fox, LAC/DP
Dennis Morrisey, NE/DP

2:30 PM Buses Leave for State Department

SCOPES OF WORK

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Policy Dialogue

State 292099
October, 1984

Subject: AID Economists Conference: Request to serve
as a panelist and instructions

Adler, Toh, Smith, Rucker, Belt, Demeraux, Van der Veen,
Allen, Lapittus

You are invited to participate in a panel discussion on policy dialogue and policy reform being held at the Conference of AID Economists in November.

As you will have twenty minutes to present your material studies, you will not be able to address all the points listed below in detail. Choose or add the topics that are most relevant to your specific country experience.

Please prepare a short paper which will be published as part of the proceedings of the conference and which will be divided into two parts.

The first part should provide a brief description, addressing, the following points:

- A. The policy dialogue/policy reform process in your country--what has been AID's role in furthering reform? What are the major obstacles and the major potential areas for further reform?
- B. How have the U.S.'s foreign policy interests in your country aided or hindered the policy dialogue process? How has the size and composition of AID resources affected policy dialogue associated with the programming of ESF?
- C. What has been the role of the IMF and the IBRD in policy reform, and what have been AID's links to IMF/IBRD policy discussions and conditionality?
- D. What has been the role of other donors in the policy dialogue process, and has donor co-ordination been effective?
- E. What sorts of problems have arisen during the process of policy reform implementation?
- F. Which program vehicles have been effective in achieving

policy reform: PL480, CIPS, HGs, Sector Programs, Cash Grants?

--G. In what ways have you been able to use projects as vehicles for policy dialogue? Which types of projects lend themselves to policy dialogue and which types do not?

--H. Have you had any success in building an institutional capacity for policy analysis within the host countries you are working with?

5. The second part of your presentation should address the role of systematic economic analysis in the policy reform process. Specifically:

--A. To what extent were the policy reforms proposed by AID guided by systematic economic analysis?

--B. To what extent were the policy changes linked to quantitative targets, and how were these targets arrived at?

--C. Were any systematic studies undertaken to underpin the policy reform agenda?

--D. Was economic analysis a part of the process by which AID's policy reform agenda was arrived at?

--E. Do you see a need for more economic analysis to be done by AID as input to underpin AID positions or policies on bank and fund conditions or for AID's own policy dialogue purposes?

Project Analysis

State 292088
October, 1984

Subject: AID Economists Conference: Request to serve as
a panelist and instructions

You are invited to participate in a panel discussion on economic analysis of projects being held at the Conference of AID Economists in November.

Please prepare a short paper which will be published as part of the proceedings of the Conference. We are looking for a discussion which addresses some of the following issues and which draws on, to the maximum extent possible, your actual experiences with projects. If feasible, please choose one or two projects with which you have recent experience as cases in point.

As you will have twenty minutes to present your paper, you will clearly not be able to address all the points listed below in detail. Choose or add the topics that are most relevant to your specific country experience.

First, please address some important general questions. In your experience:

--A. What part has the economist and economic reasoning played in the early stages of project selection and development? Is there a demand for such economic analytic input? What improvement, if any, do you think could and should be made?

--B. Do you think the economic analysis in project papers is sufficiently thorough to explain the project, or, if not, was it feasible to make improvements? How?

--C. What projects do not lend themselves to economic analysis? Is there a role for the economist in these projects?

5. Specific points to consider:

--A. How are macroeconomic conditions or factors linked to the economic analysis of projects?

--B. Do you estimate the distribution of project benefits among different population groups, and does that

distribution affect the project design?

--C. Are shadow prices used? How are they estimated, indirect benefits quantified, and discount rates determined?

--D. Are the distinctions between financial and economic analysis clearly drawn, and on which criteria is the project justified?

--E. Do you do systematic economic analysis in PL480, HG, CIPS, or other non-project instruments?

--F. What is the role of economic analysis in the evaluation of projects? Are there any links between the ex ante economic analysis and the ex post evaluation?

Economics in the CDSS

State 304773
October, 1984

Subject: AID Economists Conference: Economic Analysis in
Preparation of Country Development Strategies

Because your mission's CDSS was judged to have been among the best in the Agency in terms of its use of economic reasoning, we would like you to participate in the panel discussion on economic analysis in the development of country strategies. Jerry Wolgin (AFR/DP) will also be on the panel and Stu Callison (REDSO/E) will moderate.

Please prepare a brief paper (which will be published in the conference report) presenting your views on preparation of the economic analysis for the CDSS. We are interested in learning what you believe ought to be done to improve the process of preparing and integrating an economic analysis into the CDSS. For example, what degree of analysis is feasible, necessary, sufficient? How useful have World Bank and IMF documents been in providing data? Analysis? Is it worthwhile to obtain and/or process data independently?

How much can or should the AID strategy rest on the economic analysis that can be contained in the CDSS? Should the aim be simply to establish consistency or harmony between the strategy and the economic setting? To what extent has the strategy in your country been determined by reference to the economic situation and policy setting? Should there be a larger or more systematic analysis underpinning that in the CDSS? Should CDSS economic analysis be essentially a brief summary statement relying on work done by other donors, multilateral institutions and host country institutions?

You will have twenty minutes to present your papers so you are not expected to explore all issues. Apologies for short notice. We look forward to seeing you at the Economists Conference.

Terms of Reference for Discussion of
"Economists in AID: The Economist and Top Management"
(9 a.m. Thursday, November 8, 1984)

The problem to be discussed is partially one of communications but probably more a problem of understanding the demands on managers and the particular professional skills economists have to offer. The purpose is to air and explore the issues, not necessarily to resolve them (although you are welcome to try).

From the Managers' perspective:

- What do AID policy-makers and decision-makers need, want, expect from economists?
- What are they receiving that is useful relative to other professions?
- What do they want that they are not receiving?
- How do managers feel when or if an economist tells them a proposed or other program is not economically sound?
- Do professional qualifications make a difference to the manager, e.g., do managers prefer--or should they prefer economists with advanced training or is someone with less training just as suitable?
- What are the tasks a program economist is expected to carry out?

From the Economists' perspective:

- What major problems or misappropriate uses of economists' time do economists see?
- How can economists' time and professional skills be more effectively employed?
- What kinds of tasks should managers ask economists to perform and are there tasks which they are routinely asked to do which are inappropriate?
- To what extent should AID economists ignore the political, programmatic, or bureaucratic implications in presenting the results of their economic analyses to managers?
- What do economists have to say in advising managers on ways to increase the time economists devote to economic work (as opposed to administrative or programmatic for example), to improving their productivity and to increasing their access to needed information, techniques, or skills?

Terms of Reference for the
Plenary Session on Personnel Issues

Thursday, November 8, 1:30 pm

We would like you to be prepared to discuss a number of questions that are likely to be raised in this session. While we cannot know for sure what issues are of greatest interest to our colleagues we expect some or all of the following will need to be addressed:

- Is there any way to create a career ladder for economists that would allow promotion without requiring movement into management?
- Has Personnel given thought to the structure arising from the increased hiring of economists? In particular, is the balance between overseas and Washington posts a proper one that will allow, say two tours in Washington per career? Is there the right proportion of senior and junior economists in the system, such that junior economists can expect a reasonable opportunity for advancement up the economist career ladder?
- Does Personnel have any views on the proper organizational structure for economists in the field? Should economists be placed in the Program Office or should they have direct access to the Mission Director?
- How is the open assignment system working? Are there enough positions opening overseas for all those new hires and untenured economists who need to get a posting overseas?

For Judy Ross:

Could you provide a briefing on economist recruitment over the last two years, e.g., how many interviewed, hired, on-board, waiting for assignment, distribution to regions, missions, etc. Are we up to capacity now? What is the outlook for further additions? What is policy/practice for hiring to keep up with attrition?

Economic Analysis and the Non-Policy Pillars

AID's approach to foreign assistance and development emphasizes four "pillars": economic and social policies; the private sector; institution building; and technology. Activities related to the first of these pillars immediately and directly engage economists both in Missions and in AID/Washington, and there is a clear role for economic analysis. The role of economists and economic analysis in activities pertaining to the other three pillars is unclear. The aim of this three-hour session is to begin to clarify the appropriate role of economists and economics in AID activities centered on developing institutions, promoting the private sector, and expanding the contribution of technology.

The session would be divided into three segments (one per pillar). If more time were available it would be of interest to examine the conceptual framework underlying each pillar, and ask to what extent economic theory provides pieces of the framework or insights into the basic problem and its solution. I do not think there is sufficient time to address that topic in any satisfactory manner. I would place top priority on a discussion of specific AID activities under each pillar, and the extent to which these activities call for economic analysis of one type or another, including cost benefit analysis and analysis of policy constraints. The policy papers on "Institutional Development" (March 1983) and "Private Enterprise Development" (May 1982) provide a starting point in two instances.

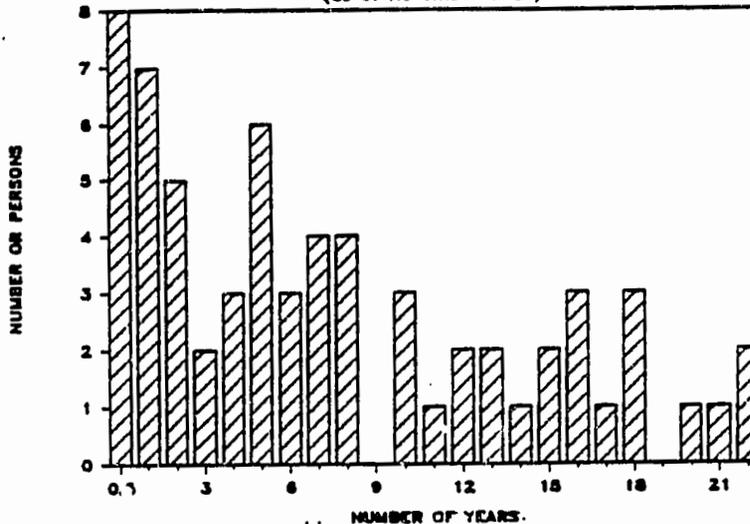
The ideal person to lead each session would be one who is an AID/Washington economist and who is (or can become) familiar with what AID is doing under the respective pillar. I could envision a presentation of 25 minutes or so followed by comments from the floor. One output of the session would be identification of activities where economists should be involved but where good technical material needs to be generated by Washington (for example issues surrounding public enterprises, economic evaluation of training programs, economic analysis of research, etc.). A second output might be identification of activities that apparently have little or no economic content and requirements for economic analysis. Project papers associated with such activities would not be expected to contain economic analysis, nor would such activities be expected to have close links to economic policy dialogue.

Mike Crosswell
ASIA/DP
October 2, 1984

SUMMARY OF SURVEY OF AID ECONOMISTS

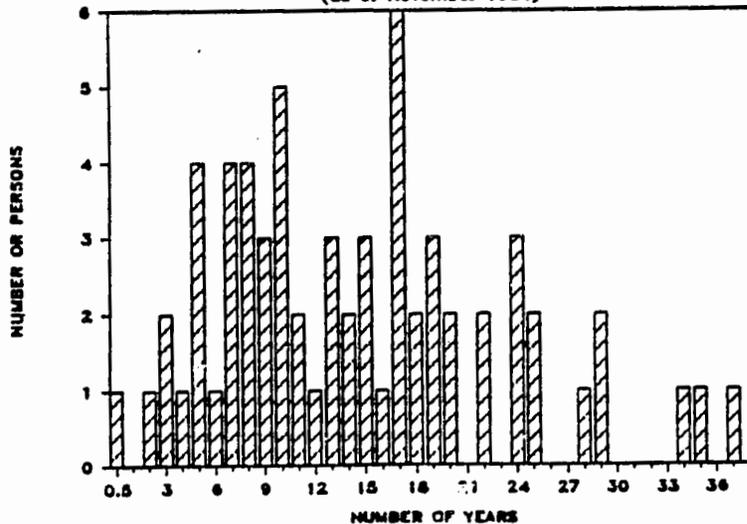
A simple questionnaire survey was distributed to participants at the beginning of the Conference in an effort to collect some information on participants' professional background, work and training preferences, distribution of work effort, views on microcomputers/software and job satisfaction. The following material summarizes the responses. There is no claim, implied or explicit, of scientific or empirical rigor. Some questions ask for the best guess. Nevertheless, some of the results are interesting. Of the 173 participants at the Conference, 80 responded to the questionnaire.

Distribution of Years in AID*
(as of November 1984)



* As of November 1984 for 61 direct-hire and agricultural economists.

Distribution of Total Experience*
(as of November 1984)



* As of November 1984, years experience prior to joining AID plus years experience in AID.

Professional Experience Prior to Joining AIP

Teaching	43 responses average of 4.7 years
Other USG	26 responses average of 3.8 years
Consulting	24 responses average of 4.6 years
Other	22 responses average of 4.7 years
Advising	9 responses average of 7.1 years
Corporate	8 responses average of 2.8 years
State and Local	4 responses average of 2.1 years

Highest Degree Attained:

	<u>Frequency</u>
PhD	45
All but dissertation	6
Master	24
BA	2
None in economics	1

Professional Work Preference Ranking (1 to 5 scale):

		<u>Frequency</u>
Macroeconomic/Policy	average rank value 4.2	
Analysis	number responding	76
	least prefer	1
	most prefer	43

Conceptual/Planning/ Policy Analysis	average rank value 4.1 number responding least prefer most prefer	75 6 37
Project Economic Analysis	average rank value 3.6 number responding least prefer most prefer	76 3 22
Economic Investigation/ Interviewing/Reporting	average rank value 3.2 number responding least prefer most prefer	73 7 16
Other	average rank value 3.2 number responding least prefer most prefer	7 2 2
Coordinating/Organizing	average rank value 3.0 number responding least prefer most prefer	69 11 8
Surveys	average rank value 2.7 number responding least prefer most prefer	70 12 7
Quantitative Analysis/ Econometrics/Modelling	average rank value 2.4 number responding least prefer most prefer	69 16 8

Areas in Which More Training Would be Useful:

<u>Title</u>	<u>Avg. Rank Value</u>	<u>Frequency</u>	<u>Composite (Avg. Rank x Freq./100)</u>
Micro	4.5	50	2.25
Macro	3.8	55	2.09
Int'l Trade	3.7	55	2.04
Project	3.5	58	2.03
Econometrics*	4.1	40	1.64

Statistics*	3.6	43	1.55
Research & Writing	3.2	47	1.50
Other (quantitative)*	4.5	12	0.54
Gen. Refresher	2.5	48	0.12
*Quantitative Methods (aggregated)	3.9	95	1.24

Note that quantitative analysis and modelling are among the least preferred activities, whereas training in quantitative methods (econometrics, statistics and other quantitative) has one of the highest preference rankings.

Training in microcomputer software

Lotus 1-2-3 was preferred by 10 respondents. Statistical programs [Microstat, (5), Stat Pak (3), SL Micro (2), TSP (1) and Shazam (1)] collected 12 responses plus one each for SAS and SPSS (which are not yet available for microcomputers). Four respondents listed dBase, two noted project development software and two listed wordprocessing.

Distribution of Work

Seventy-seven respondents guesstimated that they spend an average of 58% of total office time performing work in economics and 42% on other activities. Analytic work was reported to average about 25% of economists' time; 33% economic reporting; 27% "economic dressing"; and 16% other economics related activities. Thus, AID economists judge that they direct about 33.6% of their total work effort to the core technical activities of analysis and economic reporting.

Microcomputers

Only four respondents indicated they did not have access to computer equipment at home or in the office. Keeping in mind that some economists probably have computers in both places, 76 reported having access to microcomputers of which 23 reported having access to IBM PC; 21 to Wang PC; 5 to Wang VS80 or 100; 4 to a Wang word processor; 13 to Apple; 3 to Compaq; 2 to Kaypro; and 3 to others.

In response to the questions of how helpful economists found microcomputers to be in their work, the average rank value for 56 respondents was 3.6. The agricultural economists who answered the questionnaire valued the microcomputer most highly with seven out of eight responding, registering an average rank value of 4.5. The average rank value of general economists was 3.7, with 41 responding out of 57. Other respondents' rankings averaged 2.4 with 8 out of 15 responding.

With respect to what additional microcomputer software respondents would find useful, 24 indicated integrated programs typified by Lotus 1-2-3 (seven specified Lotus 1-2-3) or functions included in integrated programs such as graphics or spreadsheet. Twenty-five stated a preference for statistical software; 4 for math, 3 for database management and 8 (one each) for assorted functions.

Job Satisfaction

The following table summarizes replies to the question, "What do you find most/least satisfying in your job?"

<u>Item</u>	<u>Frequency</u>	
	<u>Most</u>	<u>Least</u>
1. Policy Dialogue/Analysis	12	0
2. Project Planning/Analysis	16	2
3. Opportunity to Make an Impact on the Agency	8	0
4. Variety of Work	6	0
5. Analysis	15	0
6. Interacting with Other Economists	9	0
7. Travel	3	0
8. Not Enough Time for Work	0	12
9. Irrelevant Talks and Tasks	0	26
10. Inability to Make an Impact on Agency Policy	0	4
11. Lack of Career Opportunities	0	2
12. Bureaucracy	0	3
13. Other		
Working in AID/W, monitoring research, data processing, defending basic economic principles, being away from family, report writing, redundancy, not knowing consequences of work, economists' work not taken seriously,		1 (each)
access to documentation, managing diverse staff		1 (each)

"What would you change?"

<u>Item</u>	<u>Frequency</u>
1. Give economists more time to work on economics (plus hire assistants to do administrative work)	6 (1)
2. End irrelevant tasks	5
3. Nothing	4
4. - More policy dialogue	2
- Have economist work in Mission Director's office	2
- Refresher training	2
- Emphasize <u>good analysis</u>	2
- Control requests from AID/W	2

5. More decision making power to field	1
- End irrelevant tasks	1
- Give economists their own office in missions	1
- Place economists earlier in decision-making process	1
- Give economists more authority	1
- Establish institute for long-term basic research	1
- Start in-house economic journal	1
- Merge program and project office	1
- Allow more specialization	1
- Easy access to microcomputers	1
- Support microcomputer training	1
- IDI's Washington assignment should be reduced in length	1
- More TDY's for AID/W economists	1
- Add project development officer to mission staff	1
- Add private sector officer to mission staff	1
- Involve AID/W in project development	1
- More foreign service personnel in PPC	1
- Establish responsibilities for economic analysis outside of project design	1
- "I can't begin to tell you"	1
- More professional discipline	1
- Long-term study of problems	1
- Reinstate 53/Rs minimum language requirement	1
- Work more closely with contractors	1

<u>Item</u>	<u>Comments</u>	<u>Frequency</u>
--Continue interaction among economists		3
--Most economics in AID/W is irrelevant		1
--Economists need time to do economics		1
--More job-specific training needed		1
--Decision-makers spend too much time on non-AID business		1
--More teamwork vs. clearing work		1

SUMMARY OF THE CONFERENCE EVALUATION SURVEY

A nine-question evaluation survey was distributed to participants near the end of the Conference. Thirty-six participants responded. The results are as follows:

1. Did you find the Conference worthwhile?

Yes: 34 No: 1

Some of the more detailed comments were:

"The sessions were of generally very high quality. The opportunity to share other economists' insights and views and country experience was an important feature of the Conference."

"Yes, I learned a lot, met a lot of people working in the economic field, and could interact with other AID/W people."

"Yes, especially discussion with other economists, their experiences and how they operate."

"5 (good) to 1 (awful). A courageous 3, was earned by the Conference, a 5 for the idea."

"Yes. It brings together a group of professionals and lets one another know what the others are doing."

"Marginally, but necessary as the first one. [This conference] set the stage for follow-on conferences."

"Very much so. Should do a follow-up. It was useful as a start of a process (information, interchange, dialogue) and product. To make sure a continuation of Conference as a process, we should publish or put out a product - recommendations, observations."

"Very. Exposure to concerns of Agency Program Economists important for economists in the technical backstops."

"Yes, but one each 2-3 years, with 1 year advance notice for people giving papers."

"Discussions on topics were useful and opportunity for informal sharing of ideas was most worthwhile."

2&3. What aspect(s) of the Conference did you find most satisfactory?*

* Because questions two and three are similar the results are combined.

(Paraphrased Responses)	<u>Frequency</u>
a. to meet and interact with colleagues	28
b. policy dialogue discussions	10
c. microcomputers	3
d. guest speakers	8
e. project discussions	7
f. the economist in AID	6
g. career discussions	3
h. modelling	3
i. private enterprise	3
j. other	4 (one each)

4&5. What aspect(s) of the Conference did you find least satisfactory? (typical comments)

	<u>Frequency</u>
a) too short, paced too intensively, too concentrated, too rushed, inadequate time (12); conflicting sessions (1); not enough time to interact (3); too rigid (1).	17
b) too much lecturing and not enough discussion	7
c) needed more analytical/technical sessions	6
d) policy dialogue	5
e) too long (number of days)	3
f) other	14

6. Do you recommend that AID continue to hold conferences of this type? Yes: 31 No: 0

How often?	<u>Frequency</u>
Every year	2
2 years	3
2-3 years	3
3 years	1
3-4 years	2
5 years	1
Prefer regional only	2
Prefer regional and AID-wide	4
(9 responses grouped around 3 years + 1 year)	

7. Suggestions for future Economists' Conference

Site--Washington area: 17; of which 6 preferred Annapolis. One response: "If it ain't broke, don't fix it."

Other sites--Asia (1); Africa (3); Delhi (1)

Time of year--January (2), February (2), March (3), April (2), May (3), June (1), July (1), August (0), September (3), October (3), November (9), December (0), Other than November 1 (1), After CDSS (1).

The largest three-month grouping was Sept.-Nov. with 15 responses.

Comment: "not election week"

How long?

<u>Number of Days</u>	<u>Frequency</u>
2-3	1
3	5
3-4	5
4	3
4-5	1
5	4
7	11

Topic areas:

Over twenty-five major and minor topic areas were suggested. The most frequently mentioned were project analysis (8 major, 2 minor); policy dialogue (4); international training and modelling (3 each). Career development, privatization, labor markets, research and case studies were noted two times each.

8. Was logistical support adequate?

Yes: 17; Yes+*: 4; Yes-: 6; Sum = 27;

No: 1;

9. Were accomodations and meals adequate?

Yes: 15; Yes+: 11; Yes-: 2; Sum = 28;

No: 4

*

"Yes+" is an enthusiastic positive response. "Yes-" is a positive response with reservation.