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FINAL REPORT

Factors Affecting Economic Development In The 1980s

Maurice Ernst
With contributions by Perry Wood

HI-3764/2-RR

June 19, 1985

PREPARED FOR THE
AGENCY FOR INTERNATIONAL DEVELOPMENT

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Policy Research in the Public Interest
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FACTORS AFFECTING ECONOMIC DEVELOPMENT IN THE 1980s

EXECUTIVE SUMMARY

The international economic and political environment is likely to become more favorable to the effective use of U.S. development aid in the next five to ten years than in the past decade or so. Numerous developing countries are following economic policies that are conducive to effective use of economic assistance; in particular, many are abandoning socialist/statist policies in favor of more market-oriented policies. Some countries that have not yet made major policy changes toward liberalization are probably more inclined than formerly to accept policy conditions on economic assistance of the kind that would be welcomed by the United States. The likely acceleration of economic growth in the industrial West also will spur Third World economic development, although debt problems and the impact of lower oil prices will hold some countries back.

A consensus has been building among aid donors and economic development experts on the diagnosis of economic development problems and in prescribing solutions. There is general agreement that the earlier dominant concern with the development of physical capital in LDCs was mistaken and that primary emphasis should instead be placed on human capital, especially development of skills and the creation of a climate in which entrepreneurship can flourish. There is also wide agreement on the desirability of reducing the role of government, especially in the least developed countries, because of the realization that most LDC governments lack both the skills and the political stability necessary for effective management of broad aspects of economic activity.

The increased willingness of developing countries to allow free markets to operate, and to base economic development on the private sector, reflects both growing disenchantment with the negative impact of socialist-type policies in the past and the onset of severe financial stringencies; this process has been accentuated by the economic conditions imposed by the International Monetary Fund and others on new loans. The principal changes have included large devaluations so as to achieve competitive exchange rates which support export-oriented growth, a lessening of the bias against agriculture in tax and price policy, some reduction of government interference in agriculture and trade, and, in a few cases, privatization of state-owned enterprises or steps to make them more efficient. These policy trends, if they are sustained, could have a major favorable impact on the performance of the LDC economies.

External economic forces will probably facilitate more rapid economic growth in the LDCs in the longer term, but there are substantial risks of serious problems in the next year or two. Economic growth in the industrial West should be more rapid than in the past decade. A substantial improvement can be expected in U.S. productivity performance. Western Europe is less dynamic but has begun to alleviate some of its structural

problems, especially the high and rigid labor costs. The Japanese economy should continue to do well. Overall, the industrial countries are probably capable of sustaining average annual real GNP growth rates of 3 to 4 percent over the next five to ten years. There is a possibility, however, that a large decline in the U.S. dollar, if it occurred as a sudden crash rather than a gradual slide, would trigger a new global recession during the next year or two.

Although fairly rapid economic growth in the industrial countries will generate substantial growth in the volume of world trade, the prices of most primary products, especially agricultural products and metals, are likely to be fairly weak; thus, the terms of trade of many developing countries may worsen. At the same time, the strong postwar trend of trade liberalization is unlikely to continue; indeed, there is a risk of a substantial increase in protectionism, especially if the dollar remains strong much longer.

In the longer-term the revolution in computers and communications will make it easier for LDCs to organize and manage export production to fit demand in industrial countries and to make use of modern, automatic, computerized production processes, thereby reducing demand for large amounts of skilled labor, which is a particularly scarce factor of production.

Oil prices are likely to go down, at least in real terms, and most likely in nominal terms as well. There is a substantial possibility that OPEC cooperation will periodically collapse, resulting in a big drop in oil prices, with intervening periods of price recovery due to renewed OPEC cooperation. Lower oil prices would have a favorable impact on most developing countries, but could severely hurt those developing countries that depend heavily on oil exports, or on aid or remittances from the oil exporters.

Although the most dangerous phase of the international debt crisis appears to be over, debt servicing will continue to be a heavy burden on many developing countries, and the shock of the recent debt crisis is likely to inhibit new bank loans for a long time. If rapid export growth can be sustained, the debt burden will slowly diminish and LDC economic performance will improve. This requires, however, steady growth in the industrial countries, the avoidance of severe protectionism, and a continuation of the trend in economic policy in the Third World in favor of market-oriented policies.

The chances are that the reduced activism of the past year or two in Soviet policies toward the Third World will continue, at least during the next few years. Moscow seems inclined to keep its commitment to Latin America and Africa limited and seems willing to accept losses of influence in those areas. Moscow appears more preoccupied with domestic problems and with international problems closer to home than with expanding its influence in distant places. The Soviets continue to give a high priority to the Middle East, however, and can be expected to take advantage of opportunities for intervention throughout the world, if they do not involve serious risks and are inexpensive. Apart from traditional sources of instability, such as the Arab-Israeli conflict, the Iranian revolution, the Iran-Iraq war, and Soviet support for left-wing insurgencies in the Western hemisphere, lower oil revenues could breed political instability in several areas, especially the Middle East.

The U.S. may have to substantially increase its economic assistance to countries in the Middle East and Southwest Asia. There will be powerful pressures to make up at least part of the likely decline in revenues from oil and workers' remittances to Egypt, Jordan, Pakistan, and Somalia at a time when aid funds provided by Saudi Arabia and other Southern Gulf countries will shrink. In particular, the financial burden on Jordan will surge as a result of the return of many Palestinian workers from the Gulf.

In general, the record of economic development and the increased inclination of developing countries to move away from Socialist/Statist economic policies, suggest that U.S. development aid should:

- Be focused on increasing the supply of, while minimizing new demands for, skilled labor and management in LDCs.

- Aim at breaking down barriers to small-scale entreneurship, including those created by governments, and develop institutions to spur its development.

- Make the reduction or elimination of major price distortions the primary policy condition for substantial U.S. development aid.

And given the small size of U.S. development aid (most U.S. economic aid being designed to serve national security objectives), and the growing international consensus on aid issues, the U.S. may be better able than in the past to develop common aid policies with its main allies in some multinational economic institutions, notably the World Bank. A combination of sustained pressures from both individual and multinational aid donors would greatly increase the leverage on LDC economic policies and the chances that programs of structural reforms, which were first instituted under conditions of financial stringency, will continue.

I. ECONOMIC DEVELOPMENT IN THE 1960s AND 1970s: MAJOR TRENDS AND PROBLEMS

The past two decades have seen a fairly rapid overall growth of the economies of the Third World and increasing differentiation among the countries which are classified as "developing." The fundamental causes of the great variation in growth rates are more internal than external. The fast growing countries include large, diversified, and primarily continental economies like Brazil and Mexico as well as city states like Hong Kong and Singapore, relatively resource-poor states like South Korea and Taiwan, and oil-rich states like Saudi Arabia. Apart from the obvious stimulus from the massive windfall earnings from oil in the latter group, none of the fast growing countries appear to have benefited from unusual outside stimuli. While expanding Western markets and readily available financing, provided many opportunities, some LDCs were able to take advantage of these opportunities but many were not. Import substitution was a necessary part of the process of dynamic development in the successful economies, but government attempts to promote it often resulted only in isolated islands of non-competitive production.

In a long term perspective, the successful developing countries seem to be characterized by effective use and rapid development of human resources and skills. While a good endowment in natural resources has helped to raise real incomes, it has not been an adequate substitute for the human factors of production--especially entrepreneurship and management. Indeed, attempts to sustain rapid growth primarily by spending windfalls from exports of natural resources, especially oil, have failed, except where these expenditures laid the foundations for a self-sustaining growth of human capital. For the same reason that resource rents or windfalls could not be the primary basis for economic development, so capital flows, including foreign development aid, were bound to have a limited impact in countries where skills, entrepreneurship, and management were lacking and were not being developed.

The oil boom was directly responsible for very rapid growth in such countries as Saudi Arabia, Libya, Iraq before the Iran-Iraq war, Iran before the revolution, and Nigeria before the debt crisis. It also contributed massively to expansion in Mexico during the middle and late 1970s. Oil money, through massive labor remittances and construction contracts, was largely (but indirectly) responsible for the boom in North and South Yemen, Jordan, and Pakistan. As real oil prices declined over the past three years and production in the OPEC countries fell sharply, the oil boom petered out. Oil exporting governments have been sharply curtailing their expenditures, resulting both in a slowdown in their domestic economic activity, and a repatriation of increasing numbers of foreign laborers, with consequent reductions in remittances to the countries supplying this labor. A combination of lower oil revenues and rising debt service obligations also has brought about a decline in economic activity in Nigeria, Venezuela, and Mexico, and a sharp slowdown in growth all over the Middle East. Unfortunately, few of the major oil exporting countries (Mexico and Indonesia are the principal exceptions) appear to have developed the human capital necessary to create wealth on a competitive basis in the future.

By contrast the high educational attainment of the populations of Taiwan and South Korea relative to their real income levels in the 1960s, for example, as well as the deep-seated emphasis of Sino-Japanese cultures on education, undoubtedly were major factors in the rapid economic development of these countries. Education and training help people not only to master new types of jobs quickly, but also to broaden their perspective in making decisions about work and business opportunities.

Unfortunately, neither the governments of many developing countries nor their advisors from industrial countries paid sufficient attention to the critical nature of human capital and its use until recent years. For 20 years, the predominant economic development theory in the West treated capital flows as the driving force in economic development. Because agricultural labor was believed to be grossly underemployed, investment in the non-agricultural sector, and especially in industry, was considered to be the only path to growth, and the low level of domestic savings in poor countries was seen as the principal impediment to such investments. According to this theory, capital inflows would help to increase investment in industry and related sectors, which would raise non-agricultural employment without any cost to agricultural output, since the transfer of labor would simply reduce agricultural underemployment. Detailed studies show conclusively, however, that this theory was based largely on false premises. Underemployment of agricultural labor in LDCs appears to be seasonal at worst. Consequently, large shifts of labor out of agriculture, without concommitant increases is productivity, have adversely affected agricultural production.

This relative neglect of human capital has also resulted in a widespread misunderstanding of the role of technology in economic development. Although economic growth is greatly aided by, and in many cases requires, transfers of technology from abroad, development of domestic skills and the capability to apply and diffuse technology is necessary if imports are to stimulate the development process rather than just create isolated islands of modern production. Not only management skills, but also those of foremen or master craftsmen, are often even more scarce than is capital in developing countries. Those skills are needed both to make the imported technology work and to adapt it or expand its use in a wide range of domestic production.

There has also been a tendency to exaggerate the extent to which the supply of capital is a constraint on technological development in LDC's. It is true that modern technologies used in industrial nations are rarely adapted to the conditions of at least the smaller LDC markets, and that many LDC's have encouraged capital intensive development by subsidizing capital goods (because of overvalued exchange rates or negative effective tariff protection). But not all modern technologies are capital-intensive; a growing number save on skilled labor. Moreover, even where some critical technologies are available only in capital-intensive processes, they can generally be linked to complementary labor-intensive processes. For example Japan and South Korea have generally built state-of-the-art plants to perform the central processes of steel production, but have relied on subcontractors, employing labor-intensive techniques, for much of the secondary processing.

This suggests that the appropriateness of a technology for a LDC should be viewed not mainly in terms of its capital intensity, but rather in terms of its contribution to a dynamic development process--as a part of a set of complementary production processes with both near-term and likely longer-term linkages with other parts of the economy.

In many developing countries, governments policies and activities not only have fostered economic development--for example, through education, training, and health care, by building physical infrastructure, by creating new markets, and by loosening traditional institutional barriers to economic activity--but also have impeded it because of an attempt to manage economic activity to a far greater extent than they were capable of doing effectively. In the least developed countries, where the bulk of economic activity consists of agricultural production and related trade, government involvement most often has taken the form of monopolies over the marketing of export crop, controls on wholesale or retail trade, taxes on imports and exports, and taxes or fees on a variety of services which government agents control at least partially, such as transportation and banking. Using instruments such as these, governments can have a major influence on economic activity even where government purchases of goods and services or value added in state-owned enterprises do not take up a particularly large share of the national income and products. But by interfering with prices and marketing, governments can greatly weaken the incentive to produce for the market and can thereby do serious damage to the country's principal sources of income and savings. In the higher income LDCs, such as Brazil, Mexico, Argentina, and Turkey, a large sector of publicly owned producing enterprises has also developed. When these enterprises are badly run, as is often the case, they become a severe drain on the state budget, and their financial needs can squeeze out those of the private sector. Moreover the very presence of state-owned enterprises in an industry can discourage private firms because the likelihood of discrimination.

In addition to the inherent difficulties faced by governments in dealing with conflicting criteria for economic efficiency and equity in the allocation of resources, there are two basic reasons why large scale government involvement in the economies of the developing countries has often had negative effects. The first reason is that this involvement creates added demands for sophisticated management skills, clearly the scarcest of all factors of production in the developing countries. One of the more unfortunate traits of colonialism was that virtually none of the native people were given any upper or even middle management experience. After independence, the political pressures to replace as many foreigners as possible with native managers were of course overpowering. While this process would have created severe shortages of trained managers in any event, the adoption of policies that substantially expanded the role of government--by increasing the authority of marketing boards, nationalizing foreign-owned enterprises, etc.--was bound to make the shortage even worse. And in cases where the newly independent countries adopted socialist/statist approaches, as in Ghana, Guinea, Tanzania, and to some extent India, the shortage of management skills was multiplied several fold. The second reason for the frequently negative affects of government activity was that many Third World countries, especially those of many newly independent nations, inevitably lacked stable political institutions, and their leaderships were far more concerned with political survival than with economic development. It was thus inevitable that governmental authority over economic activity would be badly administered, abused, and rife with corruption. Advanced country economic assistance programs often inadvertantly intensified the problem because the programs were management-intensive and did not take into consideration the potential for inefficiency and abuse of power where competent institutions were lacking.

Perhaps the most systematic attempt to assess the influence of government intervention on the economies of the developing countries is the World Bank's World Development Report 1983. In this report, the Bank staff calculated a so-called "distortion index" for a sample of 31 developing countries, which estimated the degree to which each country's domestic price structure differed from the price structure existing on the world market in the 1970s. This index is a composite measure of the net impact of a variety of forms of government intervention on a country's price structure. It reflects the influence of distortions due to exchange rate policy, agricultural pricing policy, import and export taxes, and domestic taxes and subsidies. The countries are grouped into low, medium, and high distortion categories, and are correlated with various measures of economic performance--the GDP growth rate, domestic savings rate, the productivity of investment, and the growth rates for agricultural production, industrial production, and exports (by volume). The results, presented in Table 1, are striking. Rates of economic growth in low price distortion countries averaged two to three times more than in high distortion countries. Moreover, the low distortion countries achieved much higher savings rates and a much higher productivity of investment than did the high distortion countries. The survey did not include Taiwan, or the Asian city states of Hong Kong and Singapore, but these are among the top economic performers, and almost certainly were among those with the least price distortion. Moreover, there were very few high distortion countries whose economic performance in any respect was up to the level of even the weakest among the low distortion countries. Although such analysis can never be conclusive because of the necessary judgments and assumptions that are required there is little doubt that price distortions due to government action have severely detrimental effects on economic development.

Table 1

INDICES OF PRICES DISTORTIONS AND VARIOUS COMPONENTS OF GROWTH IN THE 1970S

COUNTRY	DISTORTION INDEX	ANNUAL GDP GROWTH RATE (PERCENT)	DOMESTIC SAVINGS INCOME RATIO (PERCENT)	ADDITIONAL OUTPUT PER UNIT OF INVESTMENT[a] (PERCENT)	ANNUAL GROWTH RATE OF AGRICULTURE (PERCENT)	ANNUAL GROWTH RATE OF INDUSTRY (PERCENT)	ANNUAL GROWTH RATE OF EXPORT VOLUME (PERCENT)
MALAWI	1.14	6.3	14	25.3	4.1	7.0	5.7
THAILAND	1.43	7.2	21	27.6	4.7	10.0	11.8
CAMEROON	1.57	5.6	18	26.3	3.8	8.6	2.5
KOREA, REP. OF	1.57	9.5	22	31.1	3.2	15.4	20.0
MALAYSIA	1.57	7.8	20	32.6	5.1	9.7	7.4
PHILIPPINES	1.57	6.3	24	23.1	4.9	8.7	7.0
TUNISIA	1.57	7.5	27	31.4	4.9	9.0	4.8
KENYA	1.71	6.5	19	32.7	5.4	10.2	-1.0
YUGOSLAVIA	1.71	6.8	27	18.4	2.8	7.1	3.9
COLUMBIA	1.71	5.9	22	27.4	4.9	4.9	1.9
SIMPLE GROUP AVERAGE	1.56	6.8	21.4	27.6	4.4	9.1	6.7
ETHIOPIA	1.86	2.0	8	30.7	0.7	1.4	-1.7
INDONESIA	1.86	7.6	22	40.1	3.8	11.1	8.7
INDIA	1.86	3.6	20	15.6	1.9	4.5	3.7
SRI LANKA	1.86	4.1	13	22.2	2.8	4.0	-2.4
BRAZIL	1.86	8.4	22	35.5	4.9	9.3	7.5
MEXICO	1.86	5.2	22	23.4	2.3	6.6	13.4
IVORY COAST	2.14	6.7	24	25.5	3.4	10.5	4.6
EGYPT	2.14	7.4	12	24.2	2.7	6.8	-0.7
TURKEY	2.14	5.9	17	24.5	3.4	6.6	1.7
SIMPLE GROUP AVERAGE	1.95	5.7	17.8	26.9	2.9	6.8	3.9

Table 1 (continued)

INDICES OF PRICES DISTORTIONS AND VARIOUS COMPONENTS OF GROWHT IN THE 1970S

COUNTRY	DISTORTION INDEX	ANNUAL GDP GROWTH RATE (PERCENT)	DOMESTIC SAVINGS INCOME RATIO (PERCENT)	ADDITIONAL OUTPUT PER UNIT OF INVESTMENT[a] (PERCENT)	ANNUAL GROWTH RATE OF AGRICULTURE (PERCENT)	ANNUAL GROWTH RATE OF INDUSTRY (PERCENT)	ANNUAL GROWTH RATE OF EXPORT VOLUME (PERCENT)
SENEGAL	2.29	2.5	8	12.8	3.7	3.7	1.2
PAKISTAN	2.29	4.7	7	28.1	2.3	5.2	1.2
JAMAICA	2.29	-1.1	16	..[b]	0.7	-3.5	-6.8
URUGUAY	2.29	3.5	14	20.9	0.2	5.2	4.8
BOLIVIA	2.29	4.8	20	22.7	3.1	4.3	-1.6
PERU	2.29	3.0	21	21.5	0.0	3.7	3.9
ARGENTINA	2.43	2.2	22	10.7	2.6	1.8	9.3
CHILE	2.43	2.4	14	15.1	2.3	0.2	10.9
TANZANIA	2.57	4.9	12	23.9	4.9	1.9	-7.3
BANGLADESH	2.57	3.9	2	22.3	2.2	9.5	1.9
NIGERIA	2.71	6.5	21	23.8	0.8	8.1	2.6
GHANA	2.86	-0.1	9	..[b]	-1.2	-1.2	-8.4
SIMPLE GROUP AVERAGE	2.44	3.1	13.8	16.8	1.8	3.2	0.7
OVERALL AVERAGE	2.01	5.0	17.4	23.2	3.0	6.1	3.5

[a]Increase in real GDP valued at current prices divided by investment at current prices.
[b]GDP growth rates were negative.

SOURCE: World Bank, World Development Report 1983, (Oxford University Press 1983), pp. 60-61.

II. POLICY TRENDS IN LDCs

A. General Trends

There has been of late, a significant redirection of the economic policies of many LDCs towards market-based development strategies, although the fact that some countries have made changes out of economic necessity and financial pressure rather than because of a change of heart raises questions about the permanence of this shift. The role of government increasingly has been redefined from one of supplanting the market to one of supporting and supplementing the market. Such success stories of market-based development as South Korea, Singapore, Hong Kong, and Taiwan have served as examples of the possibilities inherent in such an approach. A new concern for economic efficiency has been created, along with a widespread recognition of the inefficiencies brought about by state-owned enterprises (SOEs), overvalued exchange ratios, trade barriers, and other price-distorting policies. In some countries debt service pressures, which have forced reductions in public expenditures and concentration on increasing exports, have been the driving force for change. In other countries, these pragmatic concerns have been reinforced by a new ideological commitment brought about by political change (e.g., Jamaica and Chile).

Effective market-based development in some countries has occurred in a highly regulated economic environment. Singapore, for example, has a very highly regulated economy with a great degree of government involvement. What counts is that Singapore's government does not promote inefficiency through trade barriers and an artificial price structure. South Korea and Taiwan also have highly regulated economies. In all three countries, however, the governments are stable, strong, and generally honest--a situation that is rare in the developing world.

B. Reducing Price Distortions

The most pressing issue facing economic reformers in LDCs is the reduction of major distortions in the price structure. Reform requires changes in many aspects of the economic structure of most LDCs, including labor and wage systems, trade controls, and exchange rates. Overvalued exchange rates, trade restrictions, artificial wage and price structures, and inflation all generate price distortions and such price distortions interact with each other.

Governments in many countries have begun to recognize the the inefficiencies created by price distortions. In Zaire, the government has instituted policies designed to bring down the exchange rate, established a floating exchange rate regime, dismantled exchange and trade restrictions, liberalized the domestic pricing system and interest rate structure, and improved the efficiency of public investment. Madagascar's socialist government has taken steps to reduce government intervention in the market. Guinea-Bissau has abandoned its experiment with Soviet-style development, and instituted exchange rate and domestic pricing reforms. Somalia has redesigned its structure of controls, incentives, and credit allocation to encourage private initiative in agriculture and industry. In Mexico exchange controls have been liberalized, exchange subsidies reduced, the exchange system simplified, and the exchange rate depreciated and made more flexible. Price controls have been lifted on most items; those that have been retained are applied more flexibly. In addition, adjustments in minimum wages have been kept below the inflation rate in order to reduce pressures on prices and promote employment. Various artificially low public sector prices have also been raised; and public investment has been slowed. In addition to the countries referred to above, the following nations have liberalized their import regimes in recent months and taken steps to free up their economies: Bangladesh, Haiti, India, Jamaica, South Korea, Pakistan, Tunisia, Turkey, Uganda, Kenya, the Philippines, and Panama. Even Ghana decided, in early 1983, to change course in regard to cocoa, timber, and mining, its principal export sectors. Ghana is opting for private ownership and a gradual return to market pricing in these sectors; this policy reversal has been supported by a deep currency devaluation.

The durability of these reforms is uncertain, however. They have generally come about as a result of a combination of dire economic necessity and IMF pressure. Ghana's economy was quite literally in ruin before it acted, with support from the IMF, the World Bank, and donors of bilateral aid. The extreme pressure required to force most governments to make reforms reflects the political difficulty of removing price distortions, once they are in place. Such measures usually benefit particular social groups, which fight hard to retain the support they provide. Of course, removing price distortions is only an initial victory in a protracted war. It takes a political commitment to reform by the government to insure the continuation of more rational economic policies. Countries that have made a solid commitment to market-based development include: Jamaica, Chile, Sri Lanka, Guinea-Bissau, and Guinea. India may also have joined the ranks of private sector proponents. Its new Prime Minister, Rajiv Gandhi, is pushing for a liberalization of industrial policy. His broad mandate from the recently concluded election may enable him to overcome both the opposition of special interests and the inertia of the Indian bureaucracy. He has already slashed duties on imported computers and is moving to ease restraints in the motor vehicle industry. Unfortunately, the case of Indonesia is much more typical. There the government has been forced to slash budgetary expenditures, devalue the currency, and reform the financial sector and tax structure to restore a sustainable external payments position. However, while lip service is paid to liberalization, fundamental attitudes toward competition, pricing, foreign investment, and the role of government remain unchanged.

C. Agricultural Reform

Of particular importance to Third World countries receiving large amounts of foreign economic aid is agricultural reform because agriculture in these countries employs the vast majority of the population and produces the largest share of GDP. It is essential to reverse the severe bias against agricultural producers which is reflected in the price, tax, credit, exchange rate and trade policies of many LDCs. Although specific government actions to help agriculture--such as development of agricultural extension services, dissemination of new seed varieties, and improvements in rural infrastructures, trade and services--are useful, the removal of barriers to the entrepreneurial activity of peasants and other rural people may have an even greater impact. The link between agricultural growth and overall economic growth can easily be documented, as shown in Table 2. Indeed the history of such countries as Japan, Taiwan, South Korea, Malaysia, and China suggests that a healthy agriculture is a crucial element in economic development.

Recent trends in agricultural policy in many LDCs offer hope that agriculture is at last receiving the attention it deserves. These policy shifts include such basic measures as increasing the prices paid for agricultural products, lowering overvalued exchange rates that encourage agricultural imports and discourage agricultural exports, trimming protectionist trade and industrial policies that result in increased costs for agricultural inputs, increasing investment and technical support for agriculture, and reducing the role of government agencies in marketing systems. The impact of such a redirection is most effectivly demonstrated by the case of China. From 1957 to 1977 Chinese food grain production grew at an average annual rate of 2.1 percent. Since 1977-78, however, when the government began to implement its celebrated agricultural reforms, which included a 20-30 percent increase in agricultural prices, a relaxation of production controls, and decentralization of production, food grain output has increased at a 12 percent yearly rate.

Even in Africa, where agriculture faces many disadvantages with regard to climate, soil quality, and cultivation techniques the most successful countries (e.g., the Ivory Coast and Malawi) have encouraged private farmers; the least successful (Ethiopia and Mozambique) have been those that have pursued state and collective farming methods. African countries are also beginning to push the liberalization of agriculture. At least 16 governments have lifted ceilings on farm product prices or freed them entirely. Various measures have also been announced that would reduce the role of government and government corporations in domestic marketing in favor of private or co-operative marketing. The countries concerned include: Somalia, Tanzania, Zaire, Uganda, Kenya, Madagascar, Zambia, Senegal, Niger, Mali, and Togo.

Increased agricultural incomes not only broaden the domestic market and improve the foreign trade balance, but also create capital for private entrepreneurs to invest in small-scale businesses to serve

Table 2

GROWTH OF AGRICULTURE AND GDP IN THE 1970s

AGRICULTURAL GROWTH	ABOVE 5%		GDP GROWTH 3-5%	BELOW 3%
ABOVE 3%	CAMEROON CHINA* COLOMBIA DOMINICAN REP. GUATEMALA INDONESIA IVORY COAST KENYA KOREA, REP. OF	MALAWI* MALAYSIA PARAGUAY PHILIPPINES THAILAND TUNISIA TURKEY YEMEN ARAB REP.	BOLIVIA BURMA* MALI* SOMALIA* TANZANIA*	LIBERIA NICARAGUA SENEGAL
1-3%	COSTA RICA EQUADOR EGYPT LESOTHO		BANGLADESH CENTRAL AFRICAN REP.* EL SALVADOR HAITI* HONDURAS INDIA* PAKISTAN* SRI LANKA* SUDAN* UPPER VOLTA*	BURUNDI* SIERRA LEONE* ZAIRE*
BELOW 1%	MOROCCO NIGERIA	TOGO*	ANGOLA* CHAD* CONGO. REP. ETHIOPIA* GHANA MADAGASCAR* MAURITANIA* MOZAMBIQUE* NEPAL* NIGER* UGANDA*	

*LOW-INCOME COUNTRIES (SOURCE: WORLD DEVELOPMENT INDICATORS).

SOURCE: "IN PRAISE OF PEASANTS", THE ECONOMIST, FEB. 2, 1985, P.87

both the domestic and export market. Such rural businessmen--raised in the harshly competitive world of smallholder agriculture--have often proved to be the most important actors in the development of efficient enterprises.

D. Improving Public Sector Efficiency

Another major issue for economic policy in Third World countries is the disposition or more efficient use of state-owned enterprises (SOEs). These enterprises play a particularly large role in the industrial sector, although they are also important in transportation, finance, and wholesale trade. SOEs usually obtain favored access to credit and foreign exchange, and often receive budgetary subsidies as well. Most lose money, but for a variety of reasons: i.e., past management; use for political patronage; impact of government price controls, and other price distortions. Although some SOEs provide services to the private sector, most compete with, and often squeeze out private enterprise. SOEs account for a larger share of the national income in the most industrialized LDCs, such as Brazil and Mexico, than in the low and middle-income LDCs, where agriculture predominates, although the influence of certain SOEs, such as marketing boards, on agricultural economics can be powerful.

Although broad agreement has developed in the past four years as to the desirability of reducing the burden of SOEs on the economies, and several countries--notably, Brazil, Chile, Taiwan, South Korea, Zaire, Peru, the Philippines, and Pakistan--have recently attempted to sell off their SOEs to private buyers, there has been very little actual divestiture. The only one to experience any marked success has been Chile, where approximately 130 state enterprises with a value of $500 million were sold and 250 were returned to their owners. Chile, however, is a somewhat special case. The majority of divestitures were of enterprises nationalized or created during the brief period of the Allende government in 1971-73; the clear ideological rejection of Allende's policies by the new government, combined with the brevity of the firms' public status, made it easier to divest. Even so, the eight largest Chilean companies (in terms of net worth) remained publicly-owned as of 1979--some six years after the start of the divestiture program. Other divestiture efforts have not even attempted to emulate the scope of the Chilean program.

The slow pace or failure of divestiture efforts can be partly traced to the political power of the state-run enterprises. In Brazil, for example, state-owned firms are headed by politically influential technocrats and employ a large number of the middle class (they employ 1.3 million people). Any action that directly affects such a large and influential group is political dynamite. When one considers that such interests can support their position with strongly emotive ideological appeals, it is not surprising that most governments find privatization infeasible.

The technical difficulties of financing and finding a buyer combined with the political conflict divestiture entails have increasingly shifted attention towards improving the efficiency of SOEs--trying to turn them into profitable firms. Countries as varied as Kenya, Senegal, the PRC, France, Hungary, and Ethiopia have all experimented with, or are currently experimenting with measures designed to increase SOE efficiency. These efforts have had mixed success. However, it has been clearly shown by such successes as the Kenya Tea Development Authority (KTDA) and the Ethiopian Telecommunications Authority (ETA) that SOEs can promote development, if properly managed.

Internal reforms of SOEs are dependent for their success, however, on a broader policy of freeing up the economy. It does little good to induce SOEs to operate as private enterprises if private firms themselves function inefficiently as a result of macroeconomic inefficiencies. This returns us to the notion that macroeconomic policy and price reform is the most critical element. Price distortions and restrictions must be removed in order to unleash private initiative and spur LDC development.

E. Future Pressures for Reform

The experience with economic policy reforms in LDCs during the past several years clearly indicates that economically painful, politically difficult steps are most often taken under extreme duress, when financial stringency leaves no practical alternative, or when the negative impact of past policies has grown too severe and too obvious to ignore. The fact that many LDCs will face a heavy debt service burden for at least several years, and will need to rapidly expand exports, both to service debt and to pay for the imports necessary to economic development, will help to impose a continuing discipline on LDC economic policies. It is essential, however, that the general conditions of financial prudence and macro-economic balance that characterize IMF programs be integrated into in the longer-term programs of the World Bank and of AID for economic development and structural reform. While financial pressure is the most reliable spur to reform, a change of heart about the efficacy of socialism and of certain forms of government economic activity can facilitate U.S. objectives to promote private enterprise and the free market, but only with sustained pressure on a broad policy spectrum.

III. THE FUTURE WORLD ECONOMIC ENVIRONMENT

A. Introduction

The global economic environment of the next decade or so will be more favorable to economic development in some respects, and less favorable in others, than it was in the 1970s and early 1980s. On balance, the opportunities for improved economic performance probably outweigh the impediments to such performance, but the picture varies considerably among groups of countries. The following trends can be identified:

Economic growth in the industrial countries is likely to be more rapid in the remainder of the 1980s and probably into the 1990s than it was in the past decade.

As always, technological innovations will have mixed effects. On balance, they are likely to make it easier than in the past for Newly Industrializing Countries (NICs) or incipient NICs to modernize their economies and expand their range of competitive products, but will tend to work against exporters of metals and various other raw materials.

The liberalization of foreign trade that gave world economic development strong impetus in the 1960s and most of the 1970s is unlikely to continue during the balance of the 1980s and there is a risk that trade restrictions will increase substantially.

Oil prices will probably continue to decline, at least in real terms and quite possibly in nominal terms as well, for at least the remainder of this decade. There is a substantial possibility that oil prices will become unstable, with occasional sharp declines followed by recovery to near present levels. The impact of these price patterns on various countries and groups of countries would be extraordinarily varied

Other commodity prices, notably metals and food, are likely to be weak for several years. With at least the largest developing countries (India, China, and Brazil) following policies favorable to agricultural development, with U.S. production likely to continue increasing, and with the U.S.S.R. hoping to curtail its grain imports in order to free up foreign exchange for other uses, food supplies are likely to be relatively ample and food prices relatively low for some years, on a global basis.

The carryover of the debt crisis will constrain economic development in many LDCs for at least several years, but its impact will diminish and eventually become small, if fairly rapid economic growth in the industrial West is achieved.

B. Economic Growth Prospects in the Industrial Countries

The industrial countries have an excellent opportunity to sustain more rapid growth in the next decade than they achieved in the 1970s and early 1980s. The substantial decline in growth rates during the past decade appears to have been due at least as much to temporary factors as to long term, fundamental trends. But an improvement in economic performance is by no means inevitable. Although underlying forces on balance should be more favorable to growth than they were during the past decade, an improved policy mix will also be necessary if the industrial economies are to realize their potential.

Among the fundamental favorable forces is the rate of technological change, which may be greater than in the past decade as the computer revolution and the related information revolution rapidly spread through the economies, and the probability that oil prices will continue to decline in real terms, and perhaps in nominal terms as well, for at least the remainder of this decade. Both of these factors will create opportunities to raise productivity while holding down inflation.

Trends in national economic policies also appear to be favorable, but with substantial differences among countries. Successful anti-inflationary policies in the U.S., West Germany, and Japan have pulled down inflation in the rest of the industrial countries as well. There is also a growing recognition throughout the industrial West of the need to stimulate labor and business incentives, even at the cost of reducing social welfare benefits. But although the U.S. has taken substantial steps to stimulate incentives and productivity, the Western European countries are just beginning to tackle the problem; achieving real progress will be difficult.

In the United States, high and accelerating inflation was a major cause of wasteful activity, misdirected investment, and reduced savings rates in the 1970s, while rising real and marginal tax rates together with a multiplicity of government regulations squelched incentives and substantially raised administrative costs. These problems coincided with and contributed to a tangible deterioration of the national mood--a sharp turn from optimism to pessimism about the future. The interaction of tangible and intangible factors was probably responsible for the severe worsening of U.S. productivity performance during the 1970s. By the same token, the combination of favorable recent trends--sharply declining inflation, reduced marginal tax rates, reduced government regulations, and a clear upswing in the national mood--if continued, could reasonably be expected to result in improved productivity of both labor and capital in the second half of the decade and beyond. In our view, an annual real growth rate of 3 or 4 percent for U.S. GNP is a reasonable expectation over the next decade.

The West European economies will probably grow at rates averaging 2-3 percent--less rapidly than the United States economy, but perhaps a bit faster than is generally expected. Western Europe's fundamental problem is that real wages, welfare payments, and legislation to protect labor have all grown to the point that few new jobs are created and unemployment rates are rising even in periods of economic expansion.

Real labor costs in most of Western Europe (wages and taxes on business for social insurance) grew enormously in the 1970s. At the same time, it became far easier to qualify for unemployment compensation, and extremely difficult to lay off any workers; innumerable regulations were adopted restricting the use of labor and business activity in general. And the mushrooming of social welfare costs raised government expenditures to the equivalent of something like one-half of GNP, compared with only about one-third in in the early 1970s. The private sector's response to these trends has been to treat labor largely as a fixed cost, to hire as few workers as possible, and to use investment expenditures almost exclusively to replace labor rather than to expand capacity. At the same time the rate of investment has been falling steadily, because it has been squeezed by rising consumption and government expenditures.

These trends have given rise to what is commonly called "Europessimism." But as often happens, trendiness, while capturing some important truths, exaggerates the problem, and especially underestimates the adjustment to the problem.

In fact, the Western European countries are adjusting to their problems, admittedly slowly and haltingly, but they will probably accomplish enough over a few years to improve their economic performance significantly. There are already indications that the negative trends have bottomed out. Real labor costs have levelled off or declined somewhat, and government expenditures have fallen slightly as a share of GNP. These trends will continue. Each country will adjust in its own way, although the process will be very difficult politically. Adjustment will also have some negative effects from the U.S. point of view; it is unlikely, for example, that the Western Europeans will increase military expenditures or foreign aid while they are cutting welfare expenditures.

The Japanese economy has grown faster than the United States and Western European economies during the last several decades, and will probably continue to do so. Given Japan's extraordinarily high rate of savings, its rapid rate of technical progress, the excellence of its labor force, the high effectiveness of its industrial management, and the opportunities for rapid modernization presented in such backward sectors such as retail trade and sevices, it is hard to believe that Japanese economic growth can stay below 5 percent a year for long. Japan will face difficult problems in trying to base its growth more on domestic market expansion and less on exports, and in reducing the concentration of its exports to avoid defensive foreign import restrictions. But substantial, if slow, progress is likely, on all these fronts.

Sustained real growth in the OECD of 3-4 percent annually would create a favorable environment for economic development of Third World countries. But there is a substantial risk that such growth will not be realized if the value of the U.S. dollar does not soon begin to slide downward. A continued high dollar will have an increasingly negative impact on production, income and employment in the United States. At the same time, a growing, or even constant U.S. deficit on goods and services transactions will rapidly increase the U.S. foreign debt and interest obligations, and consequently will rapidly raise the U.S. current account deficit. Eventually, and probably within the next two years, the dollar will to fall substantially. The question is whether it will fall slowly to a soft landing, or crash. In the latter case,speculative capital flows could push up interest rates and could induce more restrictive monetary policies; another global economic recession could result.

For the developing countries the high dollar thus creates some serious short-term risks. A new severe economic recession accompanied by higher interest rates would halt the LDCs' export-led recovery and make debt-servicing even more difficult, if not impossible. And a continued high dollar would create protectionist pressures that could prove irresistable. If the dollar slides to a soft landing, however, and a major recession avoided, LDC average growth rates of 4-5 percent seem quite feasible for the next few years.

C. The Impact of Technology

In principle, technological trends in the next five to ten years will widen the production opportunities of the developing countries. The computer and communication revolution will have at least two major positive effects:

It will make it easier to make export production fit demand in industrial countries. Although much progress has already been made, it should become possible to specify on a more up-to-date basis the specific requirements of Western consumer markets for a wide variety of consumer goods, such as toys, clothing, and other products that can be made in LDCs employing labor-intensive techniques. Increasingly, developing countries will be able to respond quickly to specific demands rather than be forced to seek out markets for traditional products.

Apart from rapid communications, the computer revolution will permit a wide range of industrial and other processes to be automatically controlled. The use of automatic, computerized controls makes it possible to do without much skilled labor in certain areas of production. For example, numerical controls enable machine tools to achieve tolerances that would otherwise require extremely skilled labor or could not be achieved at all. The technology for computerized controls can be developed in the industrial countries and transferred rather quickly to developing countries, because the systems can be operated without much understanding of how they work. Consequently, the use of computerized controls could considerably hasten the development of competitive new industries in LDCs.

The benefits of these technological opportunities will accrue mainly to countries that are capable of using foreign technology as part of a dynamic process, the central ingredients of which are not only access to capital, but also the development of domestic skills. It is likely that the principal beneficiaries will be countries like South Korea, Taiwan, and Brazil. Most of the other Latin American and Far Eastern countries also stand to gain considerably if they follow sensible economic policies. For the most part, the African countries are unlikely to benefit much from new sophisticated industrial technology, but they can take advantage of the increased possibilities for selling labor-intensive products to Western consumer markets. They should also benefit from the recent upsurge in research on tropical agriculture. Although major breakthroughs on the scale of the high-yielding varieties of wheat and rice developed in the late 1960s are unlikely, there is a potential for substantial improvements in the yields of various crops, especially sorghum and millet. The poor infrastructure of most African countries, however, will greatly slow the distribution of these seeds. Furthermore, even given adequate distribution, the realization of this potential will depend on the development of government policies more favorable to agriculture than those followed in the past.

D. Foreign Trade Structure and Institutions

During the 1970s, the LDCs benefited from a massive expansion of world trade, and, especially from an opening up of the U.S. market. Merchandise imports from LDCs increased from 30 percent (1970) to 47 percent (1980) of U.S. imports. Smaller, but still important, incursions into Western European and Japanese markets were made.

The rapid expansion of markets for LDC manufactures was accompanied, and greatly facilitated by, the establishment of more direct and efficient trading arrangements. These include not only inter-enterprise trade, which comprised nearly one half of total U.S. foreign trade in the mid 1970s but also direct purchases by department stores and other major outlets. At the same time, most LDCs benefited from the growing competitiveness and integration of world markets by being able to select from a growing variety of products, technologies, and services. Moreover, official barriers to trade in the industrial countries continued to be lowered during the decade, despite some new restrictions, notably on textiles.

The trends toward greater efficiency in and integration of world trade did not continue during the recession and debt crises of the early 1980s; they are unlikely to resume for the remainder of the decade. A severe shortage of foreign exchange induced many debt ridden countries to engage in various forms of barter, especially "counter-trade," under which the foreign exporter is paid partly in goods that the developing country does not normally export, and thereby incurs the burden of marketing these goods. Counter-trade is an inefficient form of trade, resulting in higher costs and substantial rigidities. As the balance of payments situation of the LDCs improves, resort to counter-trade should be reduced, but this may not happen for several years. At the same time, the number of "informal" and "voluntary" restrictions on LDC exports to industrial countries have multiplied in recent years and there is a substantial risk that growing protectionism in the industrial countries will grow further in the next few years. If the dollar continues to be greatly overvalued for another year or two, while the growth of domestic U.S. demand slows, pressures for increased protection in the U.S. would become difficult to resist. In turn, protectionism could spread to other countries.

Trade among the LDCs, although growing, will not be a major factor for the remainder of the 1980s. Trade between the NICs and other developing countries will continue to prosper, particularly in ASEAN. There should also be a resumption of the expansion of trade in the southern part of South America--among Brazil, Argentina, Uruguay, and Paraguay--as the debt crisis eases and as natural links between these countries are increasingly exploited. But trade with the OPEC countries will probably be depressed by low oil prices, and security conditions are unlikely to allow a new surge in the Central American Common Market.

A substantial, but gradual decline in the U.S. dollar--e.g., 20-30 percent over the next 2-3 years--could be expected to ease U.S. protectionist pressures. Severe restrictions against LDC exports would probably be avoided. Nevertheless, U.S. trade policy issues concerning LDC's would remain difficult, as debtor countries tried to export themselves out of their debt problem.

E. The Oil Market

For at least several years, the main pressures on the oil market will be downward. Growth of oil demand will probably be slow. Excess productive capacity will remain large for years; indeed it will increase once the Iran/Iraq war ends or Iraq otherwise regains access to the Persian Gulf for its oil exports. Pressures to raise income through increased production in countries like Nigeria, which faces serious economic and political difficulties, will also make it more difficult for OPEC to keep control of the market. Although an intensification of the Iran-Iraq war could lead to an interruption of, or substantial reduction in, Persian Gulf oil supplies, it is unlikely that any interruption would last more than a few months; thus any resulting price increase would prove temporary.

Nominal oil prices over the next several years are likely to be no higher than constant, which would mean a steady erosion in real terms. There is also a large possibility of small nominal price declines negotiated by OPEC. And there is a substantial possibility that periodic breakdowns of cooperation within OPEC would result in dramatic price drops, followed sometime later by temporary regroupings that which would permit prices to recover. Under such an unstable pattern, average prices would be down substantially, but the prevailing instability would make the planning of production and investment difficult in both producing and consuming countries.

In any event, the income of oil exporting countries will probably decline considerably, as there would be little possibility for OPEC as a whole to increase production so as to offset lower prices. As a result, the oil importing countries would save substantial amounts of foreign exchange, while countries have which benefited indirectly from oil earnings by selling labor and other contract services to the other oil exporting countries would lose income.

The impact of lower oil prices on the developing world would be far more mixed than its impact on the industrial West. In Latin America, for example, Mexico and Venezuela would lose substantially from lower oil prices, while Brazil and Chile would benefit. In Africa, Nigeria would lose, while most other countries would benefit. In the Middle East, government and private expenditures would have to be severely curtailed, not only in Saudi Arabia, the UAE, and Libya, but also in Jordan, Egypt, Somalia, the Yemens and Pakistan, which depend on private remittances and aid from the oil surplus countries.

A substantial drop in oil prices would be a major shock to the countries of the Middle East and would probably result in a large increase in the need for U.S. economic assistance to that area, especially to Jordan, Egypt, and Pakistan. How well less impacted countries could handle declines in revenue would depend on how gradually the decline occurred and on the policies followed. As mentioned above, a period of financial stringency could make it easier for governments to introduce structural reforms consistent with health, long-term development and reduced dependence on oil windfalls.

F. Other Commodity Markets

Apart from oil, commodity markets are too volatile to be readily projected years ahead. It is important to note, however, that commodity prices for the most part have not increased as much during the current economic expansion as they did during earlier periods of expansion. Indeed, metals prices have been falling in terms of U.S. dollars, as have those for a number of foodstuffs. Although prices of industrial products in terms of dollars also have been trending downward as a result of the continued appreciation of the dollar, the terms of trade of most developing countries have been worsening rather than improving--this is contrary to the normal behavior during an OECD economic expansion. With the growth of the U.S. economy slowing, and only a slow acceleration likely in other OECD countries, it is unlikely that commodity prices will be pushed up much during the present economic upswing, unless the U.S. dollar should decline sharply.

In the longer term, the outlook for metals prices is poor, because new technology will limit the growth of metals consumption, while financial necessity will continue to force metal-exporting countries to increase their production. In the case of grains, ample world supplies and relatively soft prices are likely to result from the following trends: the rapid growth of production in the large developing countries, notably China, India, and Brazil,where government policies generally favor agriculture; the vast production capacity of the United States; continued protected markets in Western Europe; and likely Soviet efforts to limit food imports in order to free up fore'„' exchange for other uses.

G. Capital Inflows and the Debt Problem

Although the most dangerous phase of the international debt crisis appears to be over, debt servicing will continue to impose a heavy burden on many developing countries, and the shock of the debt crisis is likely to inhibit the inflow of bank loans for a long time. In several of the larger debtor countries (Brazil, Argentina, Mexico, Chile) interest on foreign debt alone takes up 30 to 50 percent of earnings from merchandise exports. Although interest rates are generally trending downward, interest obligations are rising or remaining about constant, because the debt is continuing to grow. In this situation, the debt service burden can be substantially reduced only through rapid growth of export earnings. This is indeed happening in Brazil, but not as yet in most of the other Latin American countries, whose exports consist mostly of primary products facing depressed prices. 'n the case of oil exporters, rapid diversification of exports away from oil is necessary to resolve the debt problem. Mexico is making some progress in this area, but Venezuela and Nigeria are not.

Although favorable industrial country markets will facilitate export growth in the LDC debtor countries, and will eventually substantially ease the debt service burden, it will not be easy for the debtor countries to sustain internal policies that promote export growth and limit imports. While most debtor countries took drastic measures, including massive devaluations, in crisis situations because there was no practical alternative, they will find it difficult to restrain domestic economic expansion as the sense of urgency fades, the range of practical policy options widens, and, in some countries, the economic policy process becomes more politicized. The resolution of the debt problem may therefore, may follow a bumpy course, with recurring crises likely, especially during periods of imminent economic slowdown or recession in the industrial West. Moreover, while declines in oil prices will help many developing countries to deal with their debt problems, lower prices will have severely detrimental effects on a few of them.

Developing countries can expect substantially smaller net inflows of private capital than in the past decade. It is highly unlikely that banks will be willing to increase their exposure to developing countries much, as they did in the second half of the 1970s. Apart from some defensive lending by the large money market banks, there will probably be little new lending to most developing countries for several years. Some developing countries are trying to encourage inflows of direct private foreign investments, but several years of sustained efforts and good results are likely to be needed before these flows become large enough to substitute for more then a small part of the former flow of bank credit. A more promising source of new capital in the next few years would be a reversal of the massive capital flight of 1979-82, which probably exceeded $50 billion in Latin America alone. Such a reflux of capital is likely only if confidence in the political and economic stab..ity of the developing countries is rebuilt.

In general, the debt service burden, and its impact on capital inflows, should exert a substantial, but probably diminishing, constraint on economic growth in the developing countries over the next decade. Countries with the heaviest debt burdens, such as Brazil, Argentina, and Mexico, may be unable to regain previous peaks in per capita output and real income until 1990 or even later, even though their economies grew at annual rates of 4 to 6 percent. Countries with relatively smaller debt burdens will have an easier time unless, of course, their export earnings remain depressed by world price trends.

Effective management of the LDC debt problem will require an expanding world market, steady pressure on the debtor countries to undertake and sustain structural reforms of their economies, and sensitivity to political currents and reactions in both the debtor and the creditor countries. The next year or two will be particularly difficult and fraught with risks because of the high dollar and the possible global recessionary impact of a collapse in the dollar, the possibility of a big decline in oil prices, and growing protectionist pressures. Although the debt problem so far has not triggered serious political instability, except perhaps in Nigeria, political tolerance of austerity is diminishing, and the risk that debtor country governments will be forced into taking steps that are politically destabilizing will increase if external conditions do not allow a reduction in debt service burden. Political instability, whether caused by debt problems or by a major drop in oil revenues, in turn could give Moscow new capabilities for influence in the Third World.

IV. THE POLITICAL/STRATEGIC COMPONENT

A. The Soviet Role

The period of Soviet activism in the Third World, which was marked by the invasion of Afghanistan, the large scale use of Cuban troops to intervene in Angola and Ethiopia, and growing support for the radical left takeover in Nicaragua and for other left wing insurgencies elsewhere in Latin America, appears to have ended. In the past year or two, the Soviet posture outside the Middle East has been largely defensive and relatively low key.

Mozambique has been given little help in its negotiations with South Africa and in dealing with the spreading conflict with its own insurgent movement. Consequently, the left wing governments of Africa appear to be tenuously holding on to power and are further than ever from becoming advanced bases for a Soviet-supported assault on South Africa.

Moscow has faced growing difficulties in certain Third World countries where it had established a substantial presence in the late 1970s. In Angola, UNITA has steadily expanded its control over much of the countryside, and consequently has caused a shrinking of the left wing government's sources of income, to the point of almost total dependence on oil revenues from Cabinda. In Ethiopia, the Eritrean and Tigrean insurgencies continue, with little prospect of a solution. Cuban forces have been much reduced, but cannot safely be withdrawn completely.

In Central America, Soviet and Cuban aid has not been sufficient to prevent a progressive deterioration of economic conditions in Nicaragua, or a spread of influence and control by the Contras in the countryside. The left wing insurgency in El Salvador is stagnating or declining and the power of the insurgents in Guatemala has been greatly reduced in the past few years. In the Caribbean, left wing governments have been voted out of office (Jamaica), removed militarily (Grenada), or are lying low and trying to mend their fences with the West (Surinam). The Soviets and Cubans continue to work hard at covertly undermining democratic and military governments throughout Latin America, but Moscow appears to be counseling both the Cubans and the left wing elements in Latin American countries to be cautious, at least at this stage.

This apparent shift from aggressiveness to caution in much of the Third World does not appear to apply to much of the Middle East, however. Moscow has always given a special priority to the Middle East, especially to those countries with common or adjacent borders, such as Iran, Iraq, and Syria. Moscow has continued to provide substantial military aid to Iraq, has maintained its links to Iran as best it could, given the anti-Soviet as well as anti-U.S. orientation of the Iranian government, and significantly increased its military involvement in Syria.

Although Moscow has maintained a fairly constant objective of helping to liberate Third World countries from colonialism, neo-colonialism, and capitalistic exploitation, its actions have been quite pragmatic. Except in areas within easy reach of Soviet military power (the Middle East in particular), Moscow's presence in the Third World has expanded primarily in response to opportunities that could be seized without major risks of confrontation with the U.S. and without incurring major costs to the Soviet economy. In the most recent past, however, there have been no new substantial opportunities for Soviet expansion, and some communist inroads have been lost.

The more activist posture of the United States in the Third World has clearly been another major reason for the recent relatively low key approach of the Soviet Union. This is particularly the case in Central America and the Caribbean. The Grenada episode was a strong object lesson to present or potential leftist governments in the area. U.S. pressure against Nicaragua and support for the government in El Salvador is triggering some defensive measures by Cuba and the U.S.S.R., but is also inducing a cautious approach both in the strategies of the insurgents, and in the extent and form of external military support. There is little doubt that the extreme left in Latin America believes that the tide will be against them so long as the U.S. posture remains strong. In other areas, notably Africa, the impact of a stronger U.S. posture is less clear, but the anticipation of possible U.S. reactions may give Moscow additional reasons to be cautious, should opportunities for intervention arise in the future.

It is reasonable to suppose, but cannot be established, that Moscow is giving the Third World, outside the Middle East, a lower priority than it did in the late 1970s and early 1980s. The Soviet government has been faced with increasingly severe problems in several areas, notably:

The renewed U.S. military build-up;

The failure of Soviet efforts to create a serious rift between the U.S. and Western Europe;

The marked slowdown in Soviet economic growth to a rate of 2 to 2½ percent per annum;

The many signs of worsening morale and social discipline in major segments of the population, probably with adverse effects on productivity;

The prospect of even slower growth as a result of rising energy costs and reduced increments to the labor force if productivity does not improve;

The severe economic difficulties and restlessness of Eastern Europe;

The strong recent economic performance of China in response to radical economic experiments;

The prospect that the U.S. will surge ahead in the use of new computer based technologies while the U.S.S.R. will lag further behind because of economic backwardness and political constraints;

The increasing difficulty of insulating Soviet military production from the weaknesses of the civilian economy.

These fundamental problems are clearly of great concern to the Soviet government, and many of them are coming to a head at a time when a new, younger Soviet leadership has taken over. While it cannot be ruled out that Gorbachev will adopt more activist foreign policies, including those concerning the Third World, it is more likely that he will give first priority to domestic issues and to those concerning Eastern Europe, so as to establish a better base for eventual expansionary moves. Moreover, the new leadership will probably take several years to build the domestic political power base required for any dramatic policy shifts. In any event, neither Soviet history nor the logic of the current situation points to a strongly expansionary Third World policy in the near future.

The U.S.S.R.'s main appeal to Third World governments is as a highly effective model for achieving and cementing political control and a ready source of highly serviceable weapons on easy terms. These are important attractions to left wing governments or potential governments with totalitarian ambitions. However, the U.S.S.R. will not be a major factor in the economic development of the Third World during at least the next several years. Because of domestic economic constraints, Moscow is unlikely to increase its foreign economic aid substantially from recent levels of less than $2 billion a year.

Soviet trade with the Third World is likely to remain extremely small, except for military goods. Soviet exports to Third World countries were about $14 billion in 1983 in the aggregate, but more than 60 percent of these exports consisted of military goods. The remainder, about $6 billion, was less than the exports to the Third World of South Korea, for example, and only about one percent of the total imports of Third World countries--hardly a significant factor. There are no signs that the situation will change.

Moreover, the Soviet economic model no longer has any appeal as a model for developing countries. The economic problems of the U.S.S.R. developing countries that have adopted some aspects of the Soviet model have performed poorly.

B. Policies of U.S. Allies

Major changes in the policies of other industrial countries toward the Third World are unlikely during the next few years. In Western Europe, substantial increases in foreign aid cannot be expected in view of the prospects for slow economic growth and for an erosion of social welfare spending. But substantial cuts in foreign aid also are unlikely because of bureaucratic inertia and peer pressure. Japan will continue to increase its aid, but mainly in the form of export credits.

The economic presence of the former colonial nations, especially France, in Africa is often more important than direct aid. Frenchmen hold many of the high and middle level positions in Francophone African countries in both the public and the private sectors, and quite a few low level positions as well. Moreover, in return for easy access to credit from the Banque de France, the members of the CFA monetary zone accept considerable French control over their monetary policies and, at least indirectly, substantial restraints on their fiscal policies. If there should be a major flight of skilled Frenchmen from these countries, and if their tight monetary links to France were cut, severe economic instability could be the result, and already weak governments could be undermined or overthrown. Moscow might gain opportunities to fish in troubled waters and the U.S. would have to decide whether or not the stakes were sufficient to warrant a substantial U.S. involvement in the form of economic aid and/or military aid, or in extreme cases, even military intervention. But there are no signs that the French intend to reduce their presence substantially, even after several years of a socialist government which had promised to reduce the French role. A conservative French government would be even less likely to take such a step.

C. Potential Sources of Instability

The environment for U.S. foreign aid will be affected by several long-standing sources of Third World conflicts, including especially the continuing Arab-Israeli tensions and the military confrontation between North and South Korea. The cause and outcome of the Iran-Iraq war, and the uncertain development of Iran's internal revolution, also will have important implications for U.S. foreign policy and for Soviet influence in the Third World. Besides these obvious sources of trouble, the U.S. needs closely to monitor the course and impact of such for areas as:

Soviet/Cuban supported insurgencies in Central America.

The political repercussions of the debt crisis, especially in Mexico and South America.

The political repercussions of the decline in oil revenues, especially in the Middle East.

1. Latin America

Political currents in Central America and the Caribbean are clearly flowing against the extreme left, reflecting both the inability of the left to mobilize broad public support, and the inhibiting effect of a strong U.S. policy in recent years. The negative impact of left wing insurgencies on the economies of El Salvador and Guatamala is likely to diminish, but the security situation in El Salvador will have to be much improved before the economy can begin to rebuild rapidly. In Nicaragua, socialist policies, U.S. economic pressure, and the spreading activities of the contras are causing an economic slide, which is likely to continue even though the regime will probably hang on to power. The remaining left-wing Carribean governments are likely to adopt more cautious policies, and keep a low profile.

In Mexico, the ruling party will face a major test as it tries to balance political forces during a period of painful economic change. The Mexican government was able to deal effectively with the debt crisis by drastically cutting its imports, but has yet to demonstrate the political will and capability to ween the economy away from its dependence on oil and government expenditures, and to promote the private sector on a priority basis. The chances are that the ruling parcy will succeed in coopting the opposition from right and left, while pursuing compromise policies in the economic area, but a serious political split, with violent results, is a substantial possibility.

Most of South America is in the process of developing more democratic and stable political institutions and has good prospects for economic growth. Brazil is likely to continue a step-by-step process of building a democratic system, although the death of the popular civilian president-elect, Tancredo Neves, creates new uncertainties. The great majority of Brazilians appear pleased with this process and the country has been remarkably stable, despite severe economic problems and sharp cuts in real income. Thanks to a diversified and dynamic private sector and a competitive exchange rate, Brazil seems on the way to export-led economic growth. Although it will be several years before earlier per capita income levels are regained, the popular mood should improve further. In Argentina, if the Alfonsin government can bring the economic situation under control, with the military discredited and the Peronist opposition weak, it has the opportunity to build more stable political institutions. Since lack of political cohesion has been the main cause of Argentina's poor economic performance for many decades, the longer-term economic outlook could be quite favorable. In Venezuela, democracy appears likely to survive worsening economic problems due to falling oil prices and the inability to develop other major sources of income.

Most of the Andean countries, however--especially Chile, Peru, and Bolivia--face bleak economic prospects and political instability. In Chile, President Pinochet is broadly unpopular and probably owes his continued power mainly to disunity among his opponents. His unwillingness to facilitate the transition to an eventual civilian government makes a coup or a violent revolt a substantial possibility. Depressed export earnings due to lower copper prices and a heavy debt burden will make it impossible to buy off the political opposition through economic improvements. The military, however, would almost certainly prevent a left wing takeover. In Peru, politics are so fractured that the new moderate-left government seems unlikely to be able to govern successfully and undertake the structural economic changes required to deal with the debt problem and resume economic growth.

2. East Asia

The outlook for political stability in the ASEAN countries looks favorable, except in the Philippines. South Korea, Taiwan, Thailand, Sigapore, and Malaysia adjusted their economies quickly to the rising debt burden and have resumed rapid economic growth thanks largely to rapid and diversified growth of exports. The economic improvement, coupled with a degree of political liberalization, have kept political ferment in Korea within tolerable limits. The U.K. agreement with China concerning the future of Hong Kong has allayed immediate fears in Hong Kong, although confidence about the long term future remains unsteady. In Indonesia, the government has adjusted to falling oil revenues by diversifying exports, holding down spending, and generally following sensible macroeconomic policies. A further drop in oil revenues would cause a drop in living standards but probably would not trigger any serious political instability. In the Philippines the key question is whether or not democratic institutions, severely eroded under Marcos' rule, can be strengthened before his departure. If they are not, communist rebels could step into the void, which would trigger a civil war.

3. The Middle East and South Asia

There could be substantial political instability and new opportunities for increasing Soviet influence in the Middle East. The likely substantial decline in oil income, directly or indirectly, could cause major political problems in such countries as Egypt, North Yemen, Jordan, and Somalia.

Saudi Arabia will have to cut its domestic expenditures severely and probably also its foreign assistance, whether or not its oil prices hold. If they do hold, it will be partly because the Saudis have made further cuts in output. If they do not hold, revenues would also fall. Although most Saudi citizens will not suffer reductions in living standards, far fewer upper and middle class Saudis will become wealthy. The sharply reduced income prospects could erode the support that the young, educated Saudis have been giving to the government. The Saudis also have to be concerned about a possible threat from Yemen, as many thousands of Yemenite workers, formerly employed on Saudi construction projects, return home, where they will have a difficult time finding employment and new sources of income. With South Yemen already closely tied to the Soviet Union, there is clearly a potential for severe political instability in North Yemen. There also is the possibility of severe internal political instability in Iran, which could trigger Soviet military moves in that country, and of an Israeli-Syrian war, which might force Moscow to give Syria some military protection.

In South Asia, India could initiate a new war with Pakistan, with at least tacit Soviet support, if the Pakistanis pursue their nuclear bomb program. This would give Moscow the opportunity to increase its influence in the area, and the United States would lack either the means or the justification to take effective countermoves. Moreover, the loss of a substantial part of remittances from the Gulf would make it difficult for the Zia government to keep political opposition under control.

4. Africa

In Africa, many countries are likely to undergo serious political instability during the next several years. In Nigeria, lack of funds due to low oil revenues and a large debt service burden will make it difficult to bind the various regions and tribes together. The result could be a series of military coups. It may be difficult, however, for Moscow to take advantage of this instability, because it has little to offer economically, and local leftist movements are generally neither disciplined nor effective. Nevertheless, new Soviet inroads in Africa are quite possible. There will also be opportunities for Libyan mischief, although Libya's financial base is shrinking.

V. IMPLICATIONS FOR U.S. AID POLICY

The trends discussed above--a combination of improvements in the economic policies of many developing countries and generally favorable external economic conditions--suggest an opportunity for fairly rapid economic growth in the Third World during the next decade. If the OECD countries achieve an annual rate of economic growth of 3 to 4 percent, the economies of the developing countries should grow at a rate of perhaps 4-5 percent during the next few years, and more rapidly thereafter. During the next few years, economic growth will be held back in some LDCs by the debt service burden, and in other LDCs by falling oil revenues. As time goes on, however, the drag caused by the debt problem should diminish, and the positive effects of lower oil prices should more than offset the negative effects. Moreover, if the developing countries continue to follow more market-oriented policies, the cumulative favorable impact of these policies should permit growth to accelerate by the late 1980s and early 1990s.

U.S. aid policy by itself can only have a small impact on the economic development of most Third World countries--it is, and is certain to remain, far too small. But a combination of U.S. economic policies, in conjunction with those of our allies, can make a big difference. How the dollar comes down from current heights, how we manage the LDC debt problem; whether we allow protectionism to advance, will determine whether or not the potentially favorable international environment for LDC development will be realized.

With respect to the specifics of U.S. aid policy, the analysis and assessements developed in the previous chapters point fairly clearly in the following directions:

1. The critical importance of human capital in economic development suggests that development aid should be focused on: (a) increasing the supply of skilled labor and managers through education and training; and (b) minimizing new demands for this scarce human capital by reviewing programs for their impact on managerial requirements at all phases of implementation, including long-term maintenance.

2. The potentially dynamic role of small-scale entrepreneurship as an engine of economic growth in LDC's suggests that there should be a major aid effort to break down barriers to entrepreneurship, including those created by governments at various levels, and to develop institutions to spur and finance its development.

3. The clearly demonstrated, powerful negative effects of major price distortions--due for example to overvalued exchange rates, export and agricultural taxes, and industrial subsidies--on economic development performance suggest that LDC policies to reduce or eliminate those distortions should be conditions

for any substantial U.S. development aid and that this condition should normally take precedence over other conditions.

4. The trend in many LDCs in the direction of more market-oriented policies and the widespread disappointment with the results of socialist/statist policies, create opportunities to make U.S. aid more effective in spurring economic development and, in some cases, to apply policy conditions for U.S. aid more successfully.

5. The growing consensus among aid donors and economic development experts on the diagnosis of economic development problems and in prescribing solutions makes it easier to develop common economic aid policies in some international economic institutions, notably the World Bank, along lines generally acceptable to the United States.

6. To the extent acceptable common aid policies can be developed, multinational aid can be more effectively used to enhance the limited leverage of U.S. aid to encourage appropriate LDC economic policies. In particular, countries which have adopted market-oriented reforms mainly out of financial necessity are far more likely to continue such reforms if they are subjected to a combination of inducements, sanctions, and other pressures over a wide policy spectrum, and if there is better coordination between bilateral and World Bank structural reform programs, and between these and IMF programs aimed at improving economic and financial balance.

7. The reduced Soviet activism in the Third World, as well as the turn away from socialism, gives the U.S. greater flexibility in negotiating economic conditions for aid without running too great a risk of precipitating a turn to Moscow by prospective aid recipients. This assumes, however, a continued strong U.S. posture, especially in Central America and the Caribbean.

8. But the Middle East will continue to be a powder keg, with declining oil revenues affecting most countries of the area, and there is no indication that Moscow will be less willing than in the past to involve itself in Middle Eastern affairs, all of which indicates that the U.S. will be under strong and growing pressure to greatly increase its aid to that area.

This study has not attempted an evaluation of the various U.S. economic aid programs, and consequently cannot make any recommendations concerning specific programs. The effectiveness of U.S. economic aid to promote economic development, however, is severely limited by the fact that the larger part of U.S. aid--the Economic Support Fund (ESF)--is designed primarily to serve national security and foreign policy objectives, rather than economic development objectives. The two largest recipients of ESF aid--Israel and Egypt--sooner or later will have to make fundamental economic changes in their economic policies in order to sustain or resume economic growth. They are unlikely to make those changes, however, so long as they believe they can continue to count on large scale U.S. economic assistance for national security reasons. While there is no way around this policy dilemma, it is important not to focus too much on the short term objective of avoiding political conflict at the expense of long term political stability, which probably requires a healthy economy.

With respect to the geographic distribution of U.S. economic aid, there will no doubt be continued and probably increasing demands from Africa. Latin American countries and probably the Philippines will also be seeking, and may receive, increased financial assistance of various kinds, but probably not consisting mainly of economic development aid.

A substantial further decline in oil prices, or even a moderate decline, almost ensure a big increase in the demands for U.S. economic assistance in the Middle East. With Saudi Arabia and the other Southern Gulf states likely to be cutting their foreign assistance and sending many foreign workers home, it is difficult to find any source of new aid for the impacted countries other than the United States. This will probably mean more U.S. aid for Egypt even if Egyptian economic policies improve. It will probably mean increased aid needs in Pakistan and Somalia. It will mean much larger aid requirements in Jordan, which must accept the several hundred thousand Palestinians now employed in the Gulf who hold Jordanian passports. Should there be progress toward a peace settlement involving a Jordanian-Palestinian state, the aid requirements would be even greater. A massive repatriation of workers from the Gulf to North Yemen might also induce a large U.S. aid program designed to buttress that country's political stability.