POLICIES FOR GROWTH AND DEVELOPMENT IN AFRICA

A Collection of Papers Presented at
the Second Regional Conference of the
International Center for Economic Growth
African Correspondent Institutes

Abidjan, Côte d'Ivoire
April 20-24, 1993

INTERNATIONAL CENTER FOR ECONOMIC GROWTH

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PREFACE

The International Center for Economic Growth sponsored a second meeting for its African correspondent institutes on April 20–24, 1993, in Abidjan, Côte d'Ivoire. The meeting was cosponsored by one of ICEG's Abidjan-based affiliates, the Centre Ivoirien de Recherche et Economiques Sociales (CIRES). Besides the regular institute meeting, we also had a special seminar that examined African, Asian, and Latin American experiences with economic policy reform. More than 100 participants attended these events from twenty-four African countries

In addition to the participants representing our seventy-seven correspondent institutes in Africa, we invited twenty African business leaders; and the dialogue they had with policy makers and analysts turned out to be a highlight of the conference. The program also featured the participation of a number of prominent African policy makers

The papers stimulated lively discussions examining the current state of African development and its prospects. Including papers on both Asia and Latin America was particularly valuable for the conference participants because most African countries are badly in need of information about reform experiences of other countries, both good and bad. It was in fact ICEG's first major effort to focus a working meeting of institutes on sharing experiences with people from other regions.

The dialogue stimulated between the business leaders and policy makers was an important part of our efforts to encourage development of a strong private sector in Africa.

In this volume we are publishing most of the conference papers in our working papers series. The volume will be used at a series of followup subregional conferences and meetings that we are planning in Africa through 1994, and we will also distribute it to policy makers and other policy audiences throughout the continent.

In terms of the papers, although the conference was formally opened by Prime Minister Alassane Dramane Ouattara, of Côte d'Ivoire, we regret that we have no formal statement from him to include here. The collection does, however, include the papers given by Ferhat Lounes, vice president of the African Development Bank, and by four African policy makers: Kablan Duncan, deputy minister of economics, finance, and planning, Côte d'Ivoire, Kerfalla Yansane, governor of the Central Bank of Guinea; A. M Maruping, a governor of the Central Bank of Lesotho; and N. H. I. Lipumba, personal assistant to the president of Tanzania.

Three papers on economic reform and performance in Asia stimulated a great deal of interest—by Augustine Tan, of the National University of Singapore; by Mohamed Ariff, of the University of Malaya in Malaysia; and by Chung Lee, of the Univeristy of Hawaii. If anything, however, the reports on Latin American experiences—by Rolf Luders on Argentina and Chile, and by Nicolás Ardito-Barletta on Mexico—stimulated even more, perhaps because they are not as well known.

The papers in the final section touch on some of the major problems facing African policy makers. We were not able to include one additional paper from the conference—Michael Roemer's (Harvard Institute for International Development) presentation on general lessons from Asia for Africa. Dr Roemer was summarizing the conclusions of a major study whose results will soon appear in a work jointly published by ICEG and HIID under the title *Asia and Africa: Legacies and Opportunities in Development* (coedited by David Lindauer).

The paper by Paul Collier summarized the results of a three-year study cosponsored by ICEG with the World Bank. ICEG is also publishing in 1994 a separate, more complete summary of that twenty-two-country study under the title *Trade Shocks: Consequences and Policy Responses—Theory and Evidence from Africa, Asia, and Latin America*, coauthored by Jan Willem Gunning.

I should also mention that we have omitted two papers presenting interim results from ICEG research grants in Cameroun and Kenya. We will publish the full results of those projects when they are complete.

This volume, and the conference from which it appeared, is significant for several reasons. First, they symbolize ICEG's significant commitment to Africa. They also represent our first major initiative in sharing experiences between regions in ICEG's program. Since this event, we have begun development of other, similar interregional conferences, the first of which will take place in the spring of 1994 in Cairo. We look forward to doing other, similar projects in the future.

In terms of our African program, in coming months ICEG will sponsor a series of subregional conferences and local seminars, following and exploring the broad issues discussed in these pages. We will also fund on these issues a number of both individual and multicountry comparative studies, which will be undertaken by African scholars looking at African problems.

Nicolás Ardito-Barletta
General Director
International Center for Eonomic Growth

January 1994
Panama City, Panama

I
Introduction

EFFECTIVE IMPLEMENTATION OF POLICIES
FOR GROWTH AND DEVELOPMENT IN AFRICA

KEYNOTE ADDRESS BY FERHAT LOUNES
VICE PRESIDENT, AFRICAN DEVELOPMENT BANK
ABIDJAN, COTE D'IVOIRE
APRIL 21, 1993

Your Excellency, the Prime Minister
Honourable Ministers,
Your Excellencies the Ambassadors,
Director General of ICEG,
The Director of CIRES,
Distinguished Guests,
Ladies and Gentlemen,

I should first of all like to congratulate the International Center for Economic and Social Research for the kind invitation to participate in the work of this important seminar on growth and development in Africa. It provides we the Africans with an excellent opportunity to exchange our views and experiences with eminent economic specialists and operators from Asia and Latin America, two continents which have over the last few years recorded outstanding performances.

While the successes of these two regions are undoubtedly excellent examples, nobody of course, entertains the illusion that there are ready made solutions or directly transferable models. It is, therefore, with considerable caution that I venture to make some comments on the main theme of this seminar -- **The Effective Implementation of Policies for Growth and Development in Africa**, beginning with a reminder of the correlation between growth and development.

Mr. Prime Minister,

The early tradition of economics, as we will recall, made little distinction between economic growth and economic development Economic advancement was, therefore, measured by the level of real income per head; and it was only subsequently that clear distinctions began to be made between growth and development. Indeed, it was Dudley Seers who reminded us that among the key questions that need to be asked about a country's development should be included:

What has been happening to poverty?

What has been happening to unemployment?

What has been happening to inequality?

Professor Seers warned us that, if one or two of these central areas was worsening, and especially if all three were, it would be strange to call the result "development", even if real per capita income had increased significantly.

From the point of view of an institution such as the African Development Bank, the implication is clear. Poverty alleviation, income equality and employment should figure highly in our measurement of development. And, I would venture to say that if Professor Seers were with us today, he would have added at least three other questions to his list:

What has been happening to the environment?

What has been happening to gender equality?

What has been happening to human freedom?

What then, may we ask, is Africa's record in the light of these yardsticks?

Ladies and Gentlemen,

Africa today is in the throes of serious economic and social difficulties. The symptoms are manifested in the persistent decline in real per capita incomes; large fiscal and external imbalances; rapid population growth; and environmental degradation, to name only a few. In its wake, the economic crisis has increased the burden of poverty; has caused deep splits in the social and political fabric of many nations; and has, in the process, sometimes threatened their very survival. And although important distinctions can be made among individual countries -- for there have certainly been cases of success -- the overall picture is worrying.

I would even add that it is this situation that, in some instances, gives rise to the growing disillusionment and skepticism about prevailing development strategies, policies and programmes.

What then went wrong?
Who is to be blamed?
And what can be done to put Africa back on the path of sustained development?

I would submit that these are all legitimate questions to which answers must be found if Africa is to find a way out of the current crisis. The answers to these questions must enable us to draw lessons from experience. Repeating one's mistakes or those of others is a luxury that Africa cannot afford, particularly at this critical juncture in its history. However, learning from experience is not only about learning from failure but also from success. Not to draw lessons from the successes of other countries in other continents would be a serious strategic error. It is this learning excercise which will provide a partial solution towards effective implementation of policies for development and growth in Africa

Mr. Prime Minister,
Ladies and Gentlemen,

This approach stems from the idea that development can be managed. The accumulation of capital and investment were for long considered to be the key components of development management Subsequently, technical progress, human resource development, capacity building, entrepreneurship, external aid, and regional integration were emphasized. Today, environmental considerations and gender issues are recognized as the key components of sustainable development.

Regrettably, despite our increased understanding of the elements contributory to growth and development, there is hardly universal agreement on the practical mechanisms required for a country or a group of countries to grow and develop What can be readily agreed upon, however, is the notion that the management of development is a multi-dimensional process, within which there is a complicated web of interrelationships, interdependence and trade-offs.

In this respect, consider, for instance, the interdependence between the choice of a strategy, policy design and the question of effective implementation. These three aspects, though theoretically distinct, are practically insepaiable. It follows that even the best designed macroeconomic policy cannot be implemented successfully, if the overall development strategy is flawed. Similarly, the best designed projects at the micro level are virtually doomed to failure, if the macroeconomic environment is hostile. And, by the same token, a policy properly designed and implemented at the technical level, is likely to fail if it lacks the popular support and commitment of the economic operators on whom its implementation depends.

Mr. Prime Minister,
Ladies and Gentlemen,

In view of Africa's recent experiences, many important voices have questioned the appropriateness of the dominant development paradigms adopted by African nations. The strategy of import-substitution, excessive concentration on the accumulation of physical capital, the treatment of agriculture as a source of cheap resources for industry, and the heavy involvement of the State have all been challenged.

Considering, for instance, the case of import-substitution, experience has shown that reliance on this approach to development would lead, after some time, to slow economic growth and, in a number of cases, to the very breakdown of the growth process itself. Because of the high import-content of import-substitution, this approach becomes increasingly import-using and not import-replacing as it is intended. And as the demand for imports increases and eventually hits the foreign exchange constraint, idle and unutilized physical capacity are the normal consequences. These are compounded by the smallness of markets; and by shortages of skilled labor and managerial talents.

As learning from the past is important, African countries are now called upon to draw from the successful experiences of the developing world, particularly those emerging in Asia and Latin America. The lesson for Africa in this respect is that sustained development is more likely to be attained by adopting export-oriented approaches to production and growth. Relying on export markets to revive the process of development could enable firms and industries to attain the levels of production necessary for reaping the economies of scale of modern production, and benefit, at the same time, from the technological spill-overs among themselves Of course, for Africa, the theoretical conflict between import-substitutions and export promotion can be relaxed, in practice, through regional integration Output of import-substitution industries can be promoted into exporting ventures by tapping regional markets, through close coordination and harmonization of macroeconomic, trade and industrial policies.

Mr. Prime Minister,
Ladies and Gentlemen,

If it is agreed, however, that it is prudent for African countries to adopt an outward-looking, export-oriented strategy fostered by regional integration, the successful implementation of such a strategy -- or any other, for that matter -- requires, among other things, a conducive macroeconomic framework Without a set of conducive macroeconomic policies, the best designed strategies and projects can fail; and there is now wide agreement that policy reforms in the context of the familiar structural adjustment programs, will need to be implemented, reinforced and supported both financially and politically

In this regard, we are all well aware that it is now almost a decade since African countries began to undertake such reforms In view of the results that have been achieved to date, it is legitimate to ask what went wrong; especially given the high expectations attached to such reforms. But, lest we rush to judgement, let us consider the following questions:

Do we have a problem of policy design or policy implementation?

Are these macroeconomic policies inappropriate or are they simply not faithfully implemented?

Permit me to share with you some views in this respect.

There is, for instance, no quarrel that "getting prices right" is essential for any development policy to get off the ground. The macroeconomic packages fashioned by structural adjustment programs are essentially designed to achieve that end. Yet the successful implementation of the policy requires "getting right" many other things, in addition to prices.

This brings me to the important issues of timing, phasing and sequencing in relation to policy design and effective implementation. And I would venture to argue that there are five non-price factors that ought to be in place before actions on the price front can be successfully implemented. I refer specifically to **inputs; institutions; infrastructure; innovations: and information.**

Macroeconomic policies that have major impacts on price incentives can be ineffective or even counterproductive if there are not preceded by appropriate measures in these five areas. It might not be far from the truth to suggest that, in the majority of African countries which have implemented major macroeconomic reforms, actions on price incentives were not sufficient to accelerate growth and development, essentially because **inputs; institutions; infrastructure; innovations ; and information** were either lacking or inadequate.

For instance, the devaluation of the exchange rate and its supporting demand management policies which are emphasized as central for increasing export supply, growth and employment, are quite ineffective in the absence of these non-price factors. Indeed, the production effect of a devaluation may be quite neglible, if there are inefficient marketing boards or there is a large body of middlemen that reap the benefits of higher prices.

Similarly, the supply of additional output might not be forthcoming, if inputs necessary for production are not available; if there is inadequate transport that frustrates or impedes the timely delivery of both inputs and outputs; or if appropriate technologies are scare or do not exist altogether.

In short, Mr. Prime Minister actions on the price front might be sufficient only in the cases where all the necessary non-price factors are in place Indeed, the implementation of price measures in the absence of the non-price factors, I would submit, is tantamount to putting the cart before the horse.

Mr. Prime Minister,
Ladies and Gentlemen,

Closely related to those "non-price" factors which are critical to the successful implementation of price policies, are those important questions related to **markets, money, management, manpower, and motivation**, which are equally important for accelerating development.

Consider, for instance, the question of **markets**, again in the context an exchange rate devaluation. Even if all the non-price factors are in place, such a devaluation will yield positive results, in terms of increased foreign exchange earnings, only if there are adequate markets to absorb the forthcoming supply of exports -- and at prices which are not so low as to offset the potential income gains accruing from the increase in quantity supplied Indeed, the well documented deterioration in the terms of trade of producers and exporters of primary commodities, as a result of events in international markets, has more than often meant that some African countries have had to supply greater and greater amounts of exports just to keep their already meager foreign exchange earnings intact In a word, Africa has had to run faster and faster, just to stay in the same place

And what is true for markets is as true for **money, management, manpower and motivation**. For instance, the provision of adequate inputs, infrastructure, innovations, institutions and information will all require massive financial resources -- domestic, as well as foreign -- to ensure the effective implementation and sequencing of reforms And even if those resources are forthcoming in the magnitudes expected, their impact would be largely determined by the quality of administrative and managerial talents and skills -- capacities which are now lacking in virtually all sectors and countries across the Continent. Thus, we may ask:

Are African countries, in the present circumstances, capable of undertaking actions on all the said fronts simultaneously?

By asking them to do just that, are we overloading an already feeble system?

And, what precise role would we wish to assign to the State vis-a-vis the individual, in the implementation of all the necessary programmes and policies?

These are undoubtedly difficult questions which we, as development practioners, must confront squarely; but as indicated earlier, there are no easy solutions.

I am happy to say, however, that at the African Development Bank we are fully conscious of the complexities of the many arguments of the development equation. This is why over the next few years, our two overarching priorities for Africa are production growth and human resource development. To this end, a substantial share of our resources will be directed to projects and programmes which confront the issue of poverty alleviation, and more broadly speaking, the foundations of long-term development, including gender issues and the environment. In all this, we are mindful of the importance of steadiness and continuity in policy design and implementation; of the inherent danger of frequent changes in programmes, policy reversals and discontinuities in implementation; and of the importance of political stability to the development process. And on this last issue, let me say simply that the role of the government must be firm and definite, it must not be so interventionist as to undermine private incentive; or invite corruption and rent-seeking behavior; or fail to involve the broad mass of the population in decision making. Our success will ultimately be gauged not only by the financial resources we commit to Africa, but also by the quality and range of the dialogue with our borrowing member countries, on economic as well as "non-economic" issues.

Mr. Prime Minister,
Distinguished Guests,
Ladies and Gentlemen,

Permit me to conclude these brief remarks by drawing inspiration from the perplexing questions of Professor Seers alluded to earlier They point clearly to the need for modesty in the claims we make regarding the potential and actual impact of our efforts to foster economic growth and development. For clearly, economic, as well as "non-economic", and price as well as "non-price" factors; will be critical in shaping eventual outcomes The success of these outcomes will be determined by what we do on poverty, on unemployment; on inequality; on the environment; on gender issues; and, not least of all, on human freedom That, Ladies and Gentlemen, is the challenge that faces you, as it does us at the African Development Bank.

I thank you once again for this opportunity to address you and I wish you all success in your deliberations in the course of this seminar.

I thank you for your kind attention.

II
African Experiences with Economic Policy Reform

ECONOMIC ADJUSTMENT, ECONOMIC POLICY PERFORMANCE, AND DEVELOPMENT IN COTE D'IVOIRE

by

Kablan Duncan

Deputy Minister
Office of the Prime Minister
in charge of
Economy, Finance and Planning

The purpose of the policies that are in force right now in Côte d'Ivoire is to install once more the enabling conditions of a sustainable and lasting growth, by re-establishing an equilibrium and in depth reforms in the functioning mechanisms of our economy.

The roots of the crisis go back to the end of the previous decade. From 1960 till 1975, the Ivoirian economy had experienced strong and financially balanced growth based on sound policies: the development of natural resources, a strong mobilization of domestic resources, investments in basic infrastructures, in energy resources and in education, and creation of an appropriate environment for investors and producers. Agricultural productions increased and became diversified, and the country was on its way to industrialization.

After 1975, following the sharp increase in the rate of the two main products, cocoa and coffee, the State became involved in bold investments financed through surpluses stemming from the sales of coffee and cocoa, but also through large foreign loans.

By 1978, prices for cocoa and coffee fell, and the degradation of exchange terms was worsened by the second oil shock in 1979-80, resulting in a serious deterioration of the balance of payments and public finances.

Measures taken from 1981 on to remedy this situation allowed for financial stabilization. In particular, a number of public enterprises were either reorganized, liquidated, or privatized, resulting in a reduction of budget strains. Moreover, the program of public investments was drastically reduced and the foreign debt was rescheduled.

In 1985-86, growth took off again thanks to an increase in commodity prices.

Unfortunately, commodity prices fell again beginning in 1987, causing a noticeable deterioration of the terms of trade, upsetting public finances and foreign accounts once more, and forcing the country to pronounce, in 1988, a moratorium on its foreign debt. This produced another decline in economic activity. At the same time, a drop the dollar in relation to the French franc forced an appreciation in the exchange rate, hindering once more the competitiveness of Ivoirian products.

The capacity of the economy to absorb external shocks had not increased, and the country had become more dependent on foreign aid. The deficits in public finances and foreign accounts were the basis for an acute financial crisis that froze all transactions, due particularly to an accumulation of the arrears caused by such deficits.

In response to a strong public reaction, a constitutional reform took place in 1990. A post of Prime Minister was created, and it was given to Dr. Ouattara. The administration was renewed, and the administrative structures were reorganized.

A new program of stabilization and economic revival was implemented. It contained two elements, one financial, the other structural.

First Element: Financial Recovery

To revive both investment and growth, Côte d'Ivoire must, first of all, endeavor to adjust to unfavorable external conditions, settle the payments in arrears, and re-establish equilibrium.

This is going well. All producer prices have been harmonized with international price levels, with the last adjustment dealing quite recently with the price of coffee.

Public spending has been drastically curtailed. Cuts were intended for all categories of expenses, especially through a reduction of the labor force. Employment reductions included 9,000 laborers and civil servants with more than 30 years' seniority. Incidental wages for general directors and directors were reduced, and 3,000 administrative vehicles were sold.

These measures restored equilibrium in the primary balance of public finances (that is to say, the balance not counting interest on the public debt): the deficit of 224 billions in 1989 was reduced to 56 billions in 1990, and then to 33 billions in 1991. In 1992, the deficit had declined to only 7.5 billions.

Previous deficits of public finances were, however, responsible for the swelling of the domestic debt, causing the finances of enterprises to deteriorate, and making the banking system vulnerable.

A "Program of Structural Adjustment of the Financial Sector" made it possible to "clean-up" the banks' balance sheets, consolidate their refinancing, and capitalize them again. In addition, the domestic debt was restructured.

Moreover, balancing the State budget and stricter management of public enterprises reduced the holes made by the public and para-public sectors in savings and credit, which will allow their reorientation towards the productive sector. Finally, a privatization program has begun. Eight companies are already involved: the company that supplies electricity, two publishing companies, a livestock farm, a holiday encampment, and more recently, three companies in the farm-produce industry. In all, 54 enterprises will be privatized.

Restoring financial equilibrium is beginning to bear fruit. It has mostly translated into a stabilization of economic activity: the growth rate went from -3 percent in 1990 to -1.6 percent in 1991 and 0 percent in 1992.

<u>Second Element: Sectorial and Structural Measures</u>

A series of sectorial programs involved the sectors of agriculture, water and decontamination, and energy. The reorganization of the main branches of agriculture is following its course, especially those involving rice, palm oil, cotton, and hevea.

The sectors of education, health, and training are receiving particular attention in a Program of Adjustment in the Sector of Human Resources. This program aims at improving adequacy between supply and demand in the fields of health, education, and employment. What is required is to make the most of the existing means, through better planning, management, and distribution. Basic health organizations and primary education are particularly emphasized, in order to satisfy the needs of as many as possible. In addition, the unit costs of allocations and products (school manuals, medicine) have been reduced.

Furthermore, a "Program of Competitive Sectoral Adjustment" is mainly intended for the industrial sector.

1) Within this program, a first set of recent measures are meant to reduce the costs of inputs (raw materials, energy,

labor, and services) in order to restore company competitiveness.

Customs duties on raw materials have been decreased. The field of application of the VAT has progressively been enlarged, so as to avoid a break in the chain of deductions and to reduce the percentage of taxes in prices. Thus, the application of the VAT to electricy and fuel caused a reduction in energy costs.

The employers' contribution assessed on wages has also been reduced from 9 percent to 2.5 percent.

Moreover, export subsidies will be reviewed as to their principle and methods. Their assessment will no longer be based on rates of tariff protection but on extra costs borne by national enterprises, because of published tarifs and taxes.

2) A second set of measures is meant to encourage the creation of firms and the promotion of small and medium enterprises. From then on, enterprises will be exempt from licensing during their first year of activity. Furthermore, new finance mechanisms adapted to small and medium enterprises and a new technical plan of action to support developers are going to be installed.

3) A third set of measures aims at stimulating national savings. A law has recently reinforced banking secrecy. Another law instituted a new category of collective placement

organizations for securities: they are investment agencies, open-hand investments trusts, and investment clubs.

The functioning of the Abidjan Stock Exchange has been improved to enable it to play a larger role in savings mobilization and financing of enterprises. Last, a tax free savings book was instituted through the finance law for 1993.

4) Finally, the purpose of a fourth and final set of measures is to eliminate restraints in activity and employment caused by economic regulation and labor laws. Included in this program are the lifting of restrictions on foreign exchange, price liberalization, reform of laws governing competition and the job market, reorganization of merchandising networks for agricultural products, restructuration of "consular chambers" (particularly, the merging of the former chambers of commerce and industry into one organization).

If solutions to the development challenge are not refined and implemented with real commitment, our development problems will persist. What is needed is resource allocations that will allow people to put the country's material, technical, financial, and human assets to their most valuable uses, thus renewing and expanding those resources for their immediate and future well-being.

Regarding its resource base, Côte d'Ivoire is in a relatively strong position. The country possesses many assets, some inherited but mostly acquired. They lie in the political, material, and human environment that the country has developed.

Being strong, the institutions have successfully stood the test of transition to a multiparty system. Infrastructures are plentiful and of good quality. Above all, our people have many assets, especially as a result of our education and training system. This system makes available to Côte d'Ivoire a large and qualified labor force in most of its economic sectors.

These assets should attract investors, and they will manifest themselves fully as soon as the country has overcome the difficult times it is going through at the present time.

The present program seeks to achieve improved economic management through reorganization and disengagement of the State, by restoring competitiveness among enterprises and by reforming the fiscal and regulatory frameworks in which they operate. These measures should lift the obstacles that still obstruct our path to development.

ECONOMIC ADJUSTMENT, POLICY PERFORMANCE AND DEVELOPMENT IN GUINEA

KERFALLA YANSANE

SEMINAR ON THE EFFECTIVE IMPLEMENTATION OF POLICIES FOR GROWTH AND DEVELOPMENT IN AFRICA: BRINGING THE ASIAN AND LATIN AMERICAN EXPERIENCE TO AFRICA

Second Regional Conference of ICEG's African Correspondent Institutes

April 20-24, 1993
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CENTRAL BANK OF THE
REPUBLIC OF GUINEA

SEMINAR ORGANIZED BY THE INTERNATIONAL CENTER
FOR ECONOMIC GROWTH (ICEG) AND LE CENTRE INTERNATIONAL
DE RECHERCHE ET D'ETUDES SOCIALES (CIRES)

THEME:

"EFFECTIVE IMPLEMENTATION OF POLICIES FOR GROWTH AND DEVELOPMENT IN AFRICA: BRINGING THE ASIAN AND LATIN AMERICAN EXPERIENCE TO AFRICA"

SPEECH GIVEN BY MR. KERFALLA YANSANE,
GOVERNOR OF THE CENTRAL BANK OF GUINEA

THEME:

"ECONOMIC ADJUSTMENT, POLICY PERFORMANCE
AND DEVELOPMENT IN GUINEA"

CONAKRY, APRIL 1993

ECONOMIC ADJUSTMENT, POLICY PERFORMANCE AND DEVELOPMENT IN GUINEA

INTRODUCTION

As in most African countries, the economic policy observed in Guinea during the 1980s, especially in the second half of the decade, has been strongly influenced by programs of stabilization and structural adjustment implemented with the collaboration of the IMF and the World Bank.

The main reason for such a situation stems from the crisis that struck African economies at the end of the 1970s and required the adoption and the implementation of reform programs on a large scale.

Guinea, which was not spared, saw its own situation worsened further by twenty-five years of an economic policy that led the country to the brink of bankruptcy. Indeed, in spite of its unquestionable potential in the fields of agriculture, mines, hydro-electric, fishing...and its valuable human resources, as the first program of reforms was launched, Guinea exhibited the following characteristics:

- Its economic growth had been negative during the previous decade;
- Its industrial production represented only an average of 15% to 20% of installed capacities:
- Its agricultural production had almost disappeared, especially export crops;
- There was a striking dichotomy between the official market offering artificially low prices but suffering severe shortages and the parallel or informal market;
- Its administration was weighed down by excessive and often inefficient personnel;
- Infrastructure was crucially missing;

- Its education and training system was performing poorly and was not adapted to the needs of the economy;
- Its public finance had been drained;
- Its currency was overvalued as a result of an exchange rate that had remained fixed for over 10 years ($1 = 25 "sylis"); and
- Its banking system was illiquid (the liquidity rate was only 0.6%) and insolvent (75% of the assets are made up of write-offs)

Thus, within the context of such an acute crisis, in his keynote address given on December 22, 1985, President Lansana Conte launched the "Program of Economic and Financial Reforms," which is the first program of structural adjustment ever implemented in Guinea.

The goal we are tying to accomplish through this analysis is to examine, in light of the objectives assigned to the programs, the results of the policies implemented. In other words, the task is to evaluate whether the programs of stabilization and structural adjustment are likely to lead to the path of growth and development.

I. ECONOMIC ADJUSTMENT IN GUINEA

In 1986 Guinea launched its first program on structural adjustment, called Programme de Réformes Economiques et Financières (P.R.E.F.) (Program of Economic and Financial Reforms). This program had two fundamental objectives: (1) reducing the intervention of the State and redefining its role, and (2) promoting the private sector to ensure the replacement of the State in manufacturing and marketing activities.

Following the political change that took place in Guinea in 1984 these two objectives will be supported by specific policies.

Between 1986 and 1992, Guinea has experienced all typical phases of structural adjustment as defined in the IMF's philosophy: (1) stabilization, (2) restoration of growth conditions, and (3) an adjustment oriented towards growth and promotion of the private sector. Consequential measures and the social dimension of the adjustment should also be taken into account.

Thus three programs were implemented during this period:

- The first phase of the P.R.E.F. (1986-1988), supported by two consolidation agreements from the IMF;
- The second phase of the P.R.E.F. (1989-1991), supported by the Reinforced Structural Adjustment Facility of the IMF;
- The three-year program initiated in 1991 and supported by the Reinforced Structural Adjustment Facility of the IMF.

1. The Principal Objectives

As we saw earlier, the main objective assigned to these programs is, on one hand, to reduce the intervention of the State and redefine its role and, on the other hand, to promote the private sector. The main lines defined from this perspective are as follows:

- Disengagement of the State from productive industrial, commercial, and agricultural activities;
- Reinforcement of the role of the State in the realization of basic infrastructure and macroeconomic management;
- Implementation of enabling institutional, legislative and regulatory framework for economic activities.

The objectives will be carried out through two kinds of measures: (1) Those meant to bring about economic and financial adjustments, and (2) Those intended to introduce structural reforms on a large scale.

2. Reform Implementation

a. Economic and Financial Adjustments

In the first phase of the P.R.E.F. (1986-1988), the main economic and financial reforms included the reformulation of monetary policy (massive devaluation, introduction of new monetary indicators, installation of a we ˉ.ly currency auction system open to all transactions from the private and public sectors...), liberalization of economic activities particularly with the promulgation of a new investment code and fiscal harmonization, elimination of price controls, and trade liberalization. In addition, these reforms were completed by measures whose goal was to improve the management of public finances and to increase the mobilization of domestic resources.

b. Structural Reforms

Also initiated in the first phase of the P.R.E.F., structural reforms included measures taken on a scale that was unique for Africa. They included·

(1) Closure of all State banks and replacement by a new banking svstem formed by private or semi-private banks;

(2) Installation of new top executives in all governmental structures and drastic reduction in the number of civil servants (almost 50%);

(3) Restructuring and privatization of all sizable, public industrial and commercial enterprises whose number declined from approximately 180 to about 20.

II. EVALUATING THE POLICIES

These measures have produced tangible results. Following a decade of negative growth, from 1986 to 1990 Guinea's economy grew an average rate of 5% per year. In six years the inflation rate declined from about 70% to 16%, with the objective for the current year being 12%. And the restoration of a real exchange rate reduced the gap between the official and parallel markets from 1600% at the beginning of the reforms to about 5%, thus eliminating one of the main factors responsible for the lack of Guinean competitiveness outside of the country.

In terms of credit, during the first five years of the P.R.E.F. credit granted to the private sector grew an average of 50% annually, reversing the enormous prior credit allocation to the public sector. At the beginning of the 1980s, about 5% of domestic credit went to the private sector; at the end of December, this amounted to 72%.

These improvements in economic and financial indicators make it clear that the reforms have achieved their objectives. Nevertheless, most observers agree that Guinea and other African countries have had some disappointing experiences with structural adjustment.

Looking back on several years of Guinea's experience, structural adjustment in the country encouraged policy makers to change their thinking about the importance of sound economic policy. However, the structural adjustment policies have often ignored essential aspects of long-term development. These aspects are: (1) For a period generally not longer than three years, the measures taken often had nothing in common with the magnitude of the economic problems to be solved; (2) The policies have not always given national initiatives the place they deserve; (3) The policies implemented during the first years of adjustment often did not take into account the human and social dimensions of development, thus neglecting the objectives of nutrition, safety, access to health facilities, education, and employment; (4) Finally, the policies almost never took sufficient account of the sub-regional dimension and of reciprocal measures implemented in neighboring countries.

In addition, during the 1980s, net capital flows into African countries became negative around the middle of the decade, at a time when they needed an in-flow of resources to sustain their reforms.

The structural adjustment implemented in Guinea, following the example in most African countries, gave preference to the financial and regulatory policies affecting demand rather than to policies stimulating supply. In fact, with regard to structural adjustment, two approaches are traditionally accepted: policies that focus on increasing supply and policies that focus on managing demand. Policies that work on the supply side include those that overhaul the structure of economic incentives, rehabilitate the judicial and regulatory environments, promote the private sector, and so on. Supply side policies tend to take much longer to produce results than demand side policies.

Policies that focus on demand management aim at restoring balance between aggregate demand or spending and increases in national income Such policies include reformation of exchange and interest rates under a broad macro-economic regime of resource allocation dictated by the market.

Although the economic reforms implemented in African countries include measures stemming from both of these approaches, demand management has been a disproportionate priority to the detriment of reforms designed to stimulate the supply.

The Guinean experience in this connection speaks for itself. The measures taken in the first two phases of the P.R.E.F. made it possible to greatly curb, or at least to notably reduce, the serious distortions that were hindering the smooth functioning of the Guinean economy. The primary imbalances have been contained thanks largely to revaluation of the exchange rate. Nevertheless, the response from the private sector has remained below program objectives. As a result, the measures aimed at revising production did not produce their expected results, partly because they were inadequate to accomplish that result. and partly because of constraints that persist in the economic and financial environment.

We may conclude that the reforms implemented in the programs of stabilization and structural adjustment have been effective in solving short-term problems.

After several years of experience, it is hard now to avoid the conclusion that these reforms, designed for time periods rarely exceeding three years, did not produce significant results in reviving production.

In the future, however, African countries should pursue and consolidate reforms, stressing certain crucial aspects that, until now, have been largely ignored. These include increased public participation in tne reform process and increased accountability by public officials, as well as increased consideration for the human and sub-regional dimensions of development policies.

ECONOMIC ADJUSTMENT, POLICY PERFORMANCE AND DEVELOPMENT IN LESOTHO

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"ECONOMIC ADJUSTMENT, POLICY PERFORMANCE AND DEVELOPMENT IN LESOTHO"

by

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INTRODUCTION:

In Africa before independence there was talk of economic exploitation by colonial powers, among other things. Colonialists were seen as merely extracting raw materials for processing in the metropolis with little or no benefits accruing to the colonies which were endowed with those resources. Post-independence era has unfortunately been likewise disappointing. This time economic problems have been attributed to *external* and *internal, manmade* and *natural*, causes.

Among external factors can be mentioned deteriorating terms of trade. Prices of primary products which formed chief exports of most developing African countries declined while the price of imports rose, especially of petroleum products and manufactures in general. Markets for new African products remained virtually closed overseas. Hence the call for the new international economic order (NIEO) in the 1970s by the developing world. Developed countries showed no interest in the topic. As it takes two to"tango" the issue died. Some complained that colonial powers did not prepare colonies adequately for independence, thus ensuring the development of what was to be called "neo-colonialism" in political jargon. Still others felt that external donors or cooperating partners interfered too much in the design and implementation of public projects without adequate knowledge of special circumstances in each country. That is considered to have contributed, partially, to a relatively high failure rate of many development projects. In the Southern African sub-region there was also a problem of destabilisation policies by South Africa in the early to mid-1980s. This forced neighbours to divert some of the financial resources away from economic activity to defence and security.

Natural causes of economic hardships such as droughts, especially in the first half of the 1980s and floods have to be recognised.

There were internal factors which also contributed to economic decline. There was either insufficient, or total lack of involvement of the wider population (i.e., popular participation) in the development effort. Governments overloaded themselves with purely economic activities. Nationalisation became fashionable. Absence of sophisticated indigenous entrepreneurial cadre was cited as one of the major reasons for this action. State capitalism became the order of the day. Non-Governmental development oriented organisations (NGOs) were erroneously identified as competitors for popularity with voters and their efforts were at times frustrated. Meritocracy was in some instances replaced by nepotism. Elements of corruption and violation of human rights became evident in some cases. Misuse of human resources, their dislocation and exodus ensued. Experimentation with economic systems that later proved unworkable was another phenomenon in some cases. In many cases economies were not properly managed. The economy was allowed to drift farther from being production oriented to being consumption oriented too early. Government expenditure became excessive and for that matter it was largely on non-productive activities. Population grew at a faster rate than economy's productive capacity was expanding.

The picture in the end became very gloomy indeed. Fiscal deficits became very high. Debt burden, internal and external, became very heavy. Balance of payments problems ensued. Exchange rates were distorted. Inflation was raging at alarming rates. Poverty became more intense. In a number of cases real GDP declined. More joined those below poverty datum line. The already inequitable distribution of income and wealth became worse. Private foreign investment tapered off due to inclement socio-political and economic climate. Indigenous entrepreneurial cadre remained small and demoralised. The environment deteriorated. This strenuous situation led to unrest resulting in civil wars and coups and counter coups.

A growing number of governments recognised the need to commit themselves to economic reform and recovery. They accepted the need to change economic policy approach. By mid-1980s a number of governments were already resorting to economic structural adjustment programmes (ESAPs) in order to redress the situation. By the second half of 1980s many were following an ESAP of one type or another. Most were International Monetary Fund and World Bank supported programs. All ESAPs were aiming primarily at stabilising the economy, correcting imbalances, removing obstacles in the system, relieving the government of excessive economic activity burden and shifting resources to productive activities, thus putting the economy on a path of sustainable growth. The bottom line was achievement of improved economic management and emphasis on productive activities, by both the public and the private sectors. By January 1993, four Sub-Saharan Africa countries were following a Structural Adjustment Facility (SAF) supported programs. Nineteen, all but six being African countries, followed Enhanced Structural Adjustment Facility (ESAF) supported programmes (IMF) Survey, March 8th, 1993, p. 76). There were also United Nations initiatives aimed at Africa's economic recovery.

Lesotho has not been an exception to this sad economic history. After years of socio-economic and political malpractice the economy did deteriorate and in an accelerating fashion. Due to lags in economic phenomena some of the results of mismanagement in earlier years only became fully manifest and lingered on after a time interval of years. The new regime identified and appreciated the magnitude of the problem. The decision was to take corrective measures through the medium of economic structural adjustment programme (ESAP) in partnership with the International Monetary Fund (IMF) the World Bank and other cooperating partners. The programme commenced in fiscal year 1988/89.

With a track record of about a decade with economic structural adjustment programmes in Africa, it is time to take stock. Have these programmes worked or not? Where they did not work as expected what were the reasons underlying failure to meet expectations? In short what are the lessons of experience?

The purpose of this paper is to share the experience of Lesotho in the economic structural adjustment endeavour from 1988 to 1992. In the process it will be possible to derive lessons of experience which can still prove useful to others.

First the profile of the economy of Lesotho will be given. The economic situation before economic structural adjustment programme will be described. Policy measures adopted and their objectives will be indicated. Results of the effort will be shown. An attempt will then be made to draw lessons of experience from the case of Lesotho and from other cases as well.

2. PROFILE OF LESOTHO'S ECONOMY:

Lesotho's economy is small in size as Table 1 reveals. Table 1 compares Gross Domestic Product (GDP) of Lesotho to those of its neighbours for 1991. The size of its GDP is about 17 per cent that of Botswana and about 61 per cent that of Swaziland. The resource base is narrow. Major exports are wool and mohair and manufactured products. The major markets are the Southern African Customs Union (SACU), North America and European Economic Community. Over one hundred thousand, in a population of about 1.9 million, work abroad as migrant workers. Net factor income from abroad forms over 40 per cent of the Gross National Product (GNP). This means that GDP forms less than 60 per cent of GNP. The difference between GDP and GNP is substantial. Table 2 shows sectoral contributions to the GDP. The Primary Sector lost ground with a contribution of about 19 per cent in 1987 which was down to about

14.4 per cent by 1991. The Secondary Sector gained much ground by contributing about 37.4 per cent in 1991 as against 27 per cent in 1987. This was due mainly to manufacturing and construction, especially the latter. The Tertiary sector held its ground, with its percentage contribution declining only marginally.

The economy of Lesotho is very open. The degree of openness is reflected by a ratio of 94 per cent of exports plus imports over GNP in 1991, and of 121 per cent if net factor income from abroad is added to exports of goods and imports from SACU in the numerator. It is open and dependent, especially on the South African economy. In 1991, about 87 per cent of imports came from SACU and about 30 per cent of exports went to SACU.

The average level of income is still very low by international standards. In 1991 real GNP per capita was only about 135 American dollars. Lesotho used to be known over two decades ago for comparatively fairly equitable distribution of income and wealth. Over the last two decades distribution of income and wealth have become greatly skewed. (Jan A. Aklof and Peete Molapo, "Distribution of Incomes and Consumption in Lesotho: A Study on the 1986/87 Household Budget Data" Central Bank of Lesotho Occasional Paper No. 4)

Lesotho is a member of the Southern African Customs Union (SACU). The other members are Botswana, Namibia, South Africa and Swaziland. SACU dates back to 1910. It permits *inter alia* free flow of goods and services and factors of production. Lesotho is also a member of the Common Monetary Area (CMA) with Namibia, South Africa and Swaziland. It allows *inter alia* free flow of funds among members and similar exchange control guidelines. Lesotho enjoys membership in the Southern African Development Community (SADC), the successor to the Southern African Development Coordination Conference (SADCC) and in the Preferential Trade Area for Eastern and Southern Africa which is preparing to be transformed into the Common Market for Eastern and Southern Africa (COMESA).

3. MACROECONOMIC INDICATORS IN THE PERIOD PRECEDING ECONOMIC STRUCTURAL ADJUSTMENT:

Lesotho's real GDP growth decelerated from the already low 3.5 per cent in 1985 down to 2 per cent in 1986 (Table 7). Fiscal deficit was deepening at an alarming rate. It worsened from 4 per cent of GDP and 2 per cent of GNP in 1984/85 to 19.5 per cent of GDP and 10.3 per cent of GNP in 1987/88 (Table 3). Capital Expenditure as a ratio to Total Government Expenditure dropped from 31.2 per cent in 1985/86 down to 28.1 per cent in 1986/87 (Table 4). Gross National Savings as a percentage of GNP declined from 24 in 1985 down to about 22 per cent in 1986 and 1987. It dropped further to about 19 per cent in 1988 (Table 6). Even as a percentage of GDP it followed similar movements. Fixed Capital Formation as a percentage of GNP declined from 23.2 down to about 19 in 1986 and 1987 (Table 5). Indeed similar movements were observed when expressed as a percentage of GDP. Domestic credit was rising at an alarming rate, out of step with the real growth rate of the economy. It rose by 72.2 per cent from 1985 to 1987. Government was crowding out the private sector in the allocation of domestic credit. By March 1988, 60 per cent of net domestic credit went to the Government leaving only 40 per cent for the private sector. The External Current Account balance as a percentage of GNP was deteriorating from +1.5 in 1985 down to -1.8 in 1986 and further down to -8.3 by 1988 (Table 9c). Official foreign exchange reserves in terms of weeks of import requirements had been declining from about 12 weeks of imports in 1986 to a mere 8 in 1988 and 7 in 1989 (Table 10). Inflation rate (based on the consumer price index), already at double digit level, escalated from 13.3 per cent in 1985 to 18 per cent in 1986, then dipped down to about 12 per cent in 1987 and 1988 (Table 8).

A wide variety of macroeconomic indicators were clearly pointing to the economic situation that was rapidly deteriorating. There was a dire need for a resolute action by way of intervention aimed at containing the worsening resource imbalances and putting the economy back on track of stability and sound growth.

This is the economic situation that led the Government of Lesotho to choose to undertake an economic restructuring programme.

4. AIMS AND OBJECTIVES OF LESOTHO'S E.S.A.P.:

The primary aim of ESAP was, and remains to be, to stabilise the economy and put it back on a path of sound and sustained real growth. It aimed at stabilising the economy while at the same time (a) improving allocation of resources by correcting distortions in the system, (b) removing obstacles to growth and (c) nurturing activities that led to sound and sustained growth.

These aims were to be attained by pursuing the following specific objectives:

(i) Reducing Government fiscal deficit to manageable levels or preferably eliminating it altogether;

(ii) narrowing current account deficit, or preferably wiping it out altogether in order to restore balance of payments viability;

(iii) curbing inflation;

(iv) striving for efficient and properly directed allocation of resources;

(v) clearing the economy of structural impediments;

(vi) promoting the development of directly and indirectly productive activities.

These were considered the guiding lights for specific measures which were to be adopted for the achievement of the ultimate aim, namely, a strong and sustainable economic growth under stable conditions.

5. POLICY MEASURES TAKEN TO ATTAIN SET OBJECTIVES:

A variety of fiscal, monetary and incomes policies as well as structural measures, were adopted as means of achieving set objectives.

Fiscal policy aimed at reducing fiscal deficit by (a) raising revenue level, (b) and containing recurrent expenditure, which at the same time (c) encouraging well planned capital expenditure. Raising of revenue level involved attempts at (i) improvement of the tax structure and the (ii) strengthening of the revenue collection machinery. Alarming escalation of Government expenditure was to be curbed by (i) cutting off dispensable items from the budget, (ii) instituting tighter controls to avoid waste and leakages and (iii) by monitoring the situation closely and making necessary adjustments in the process.

Sufficiently tight monetary policy aimed at bringing money supply and domestic credit in line with the growth rate was pursued. Interest rates and domestic credit ceilings were preferred instruments. Government domestic borrowing from the banking system, in particular, was to be drastically cut so that the remaining credit allocation could be directed to the productive activities in the economy. This was expected to follow automatically as fiscal deficit diminishes. Public sector external borrowing on commercial terms was contained. A limit was set. The rationale behind this kind of monetary policy is that when excessive credit expansion is curbed to a level consistent with envisaged growth rate inflation will tend to be arrested. Means of payment in the economy will be somewhat dampened. Imports will tend to be contained, and therefore, the external current account balance would tend to improve. Furthermore, in a situation such as that obtaining in Lesotho where the economy is highly open and inflation is largely imported, the rate of inflation is somewhat further contained by decelerating increase ;in imports. Interest rates and exchange rates were to follow the market trends.

Incomes policy was used to a very limited degree. It involved orderly upward revision of wages and salaries. In the public sector there was direct control. In the private sector control was merely by way of setting minimum wage level. Because of persistent inflation considerable public pressure was exerted against tight wage controls. Authorities have had to accommodate such pressures but in a measured way. Price control of any sort has not been resorted to.

In addition to stabilisation policies mentioned above, there were also a number of policy measures adopted which aimed at eliminating structural impediments in the system, promoting efficient use of resources and supporting directly productive activities of the economy in various sectors. They addressed agriculture, industry, trade, financial services, public service and related areas. These structural measures encompassed, *inter alia*, (a) improved use of natural resources (that is, land use and environmental protection); (b) commercialisation of utility corporations; (c) privatisation, commercialisation, trimming down or liquidation of some statutory bodies (parastatals); (d) civil service reform aiming at a slim but efficient administrative machinery; (e) financial sector reform to enable it to serve the economy more effectively and efficiently; (f) promotion of private investment, domestic and foreign in industry and trade and (g) promotion of agricultural production.

The financial sector mentioned in (e) above was to be developed further so as to (i) enable efficient mobilisation and allocation of bank and non-bank financial resources and (ii) at the same time devise additional monetary policy instruments.

Successful pursuit of all these policies was expected to halt and reverse disturbing trends in the economy. The stage for strong and sustained growth would be set.

6. RESULTS BY 1991/92:

The first year of ESAP was characterised by slippages because of (a) what turned out to be rather rushed preparations; (b) very slow pace of implementation of policies at the beginning; (c) rigidities characteristic of developing economies; and (d) the usual economic lags. These will be elaborated upon later. Positive results began to manifest themselves in 1989/90 fiscal year.

Success was relatively greater with respect to stabilisation policies. Fiscal deficit, after the worst position of -19.5 per cent of GDP and 01-.3 per cent of GNP in 1987/88, began to improve systematically from 1988/89 at -16.6 per cent of GDP and 9.2 per cent of GNP to -0.5 per cent of GDP and -0.3 per cent of GNP in 1991/92. 1992/93 registered a surplus of about +0.4 per cent of GDP and about +0.2 per cent of GNP (Table 3). Gross National Savings rose from a low of 18.9 per cent of GNP and 34.3 per cent of GDP in 1988 to a higher level of 45.3 per cent of GNP and 78.4 per cent of GDP in 1990. Preliminary estimates put it at 51.5 per cent of GNP, 85.4 per cent of GDP for 1992 (Table 6). Fixed capital formation rose from 39.9 per cent of GDP and 22.7 per cent of GNP in 1988 to 63.3 per cent of GDP and 41.2 per cent of GNP in 1991 (Table 5). Capital expenditure increased from 40.6 per cent of total Government expenditure in 1988-89 to 45 per cent in 1990/91. The ratio slid down to 36.4 in 1991/92, and to about 35 per cent in 1992/93, (Table 4). Delays in the implementation of major projects has been cited as one of the reasons underlying the decline. Another being a comparatively more rapid increase in expenditure on salaries. Share of Government in domestic credit declined continuously from 1989 when it was 60.8 per cent and the private sector got 39.2 per cent to March 1992 when Government's share was only 6.8 per cent while the private sector share had become 93.2 per cent (Table 11). Whereas total net domestic credit had risen by 72.2 per cent over 1985-87 period, which yielded an average annual rate far in excess of the then prevailing inflation rate and real growth of GDP, over 1990-92 it declined by 22.23 per cent. It was thus successfully contained. Credit to private business enterprises increased tremendously over 1990-92 period. This had to be so as the crowding out process by Government was being reversed in addition to normal desirable growth. The assumption being that the private sector ought to be more productive than the Government, growth prospects ought to have been improved as a result. Later in 1992 the Government actually became the net creditor to the banking system. This position has been strengthened in 1993 so far (Table 11, 12 and 13).

Current account balance as a percentage of GNP improved from -8.3 per cent in 1988 to -1.0 percent in 1991 and is estimated to have been positive in 1992 (Table 9c). Official foreign exchange reserves covered about 11 weeks of imports in 1990 and 1991 and above 12 weeks in 1992 (Table 10). Inflation rate (using consumer price index), which is largely imported as pointed out earlier, remained at double digit level, ranging from 11.5 per cent to 17.9 per cent between 1990 and 1992 (Table 8). External debt as a percentage of GNP remained steady over the period 1989-92, with a range of 34.2 per cent and 36.2 per cent (Table 9b). Debt service ratio remained well below the danger level of 25 per cent. It ranged between 4.7 and 3.8 over the period 1989-92 (Table 9a). On the overall ESAP is beginning to bear fruit, especially in the area of stabilisation.

Regarding removal of structural obstacles and support of directly and indirectly productive activities, although set deadlines were not met in a number of cases, some progress has subsequently been made. It has been a somewhat slow progress. Pace is now quickening, however. Commercialisation of utility corporations and privatisation process of selected parastatals, as well as liquidation of non-performing ones, is ongoing. Legislation regarding land reform has been passed. Tax system is being restructured. Securities market development has commenced. Financial deepening in general is being pursued. Efforts to establish equity market are afoot. Targeted credit and guarantee schemes are in place to stimulate indigenous entrepreneurship. Extension services to lend support to indigenous entrepreneurs have been expanded and consolidated. It is civil service reform that has lagged behind.

It could be re-emphasized, therefore, that while stabilisation policies achieved reasonable results, the actual restructuring of the economy moved rather sluggishly due to usual rigidities and low implementation capacity in developing economies. The process seems to be gathering momentum, however.

There are those who believe that ESAPs tend to dampen growth. This view is not accurate unless the programme in question is poorly formulated or implementation is faulty. A good ESAP should set a stage for a strong and sustained growth. The decline in real growth rate of GDP, from 12.9 per cent in 1988 to 11.8 per cent in 1989 and then to 5.0 per cent in 1990 and further down to 0.9 in 1991 in the case of Lesotho is not due to ESAP. In fact without ESAP the drop could have been sharper. Perhaps negative rates of growth could have been experienced. The decline is to some degree due to repatriation of some migrant workers plus deceleration in wage rate increases in the South African mines; natural disasters that affected agricultural output and powerful external shocks as well as general slow down in the global economy, especially a recession in neighbouring South Africa. Lesotho is vulnerable to external shocks because it is a small, highly open and dependent economy. Because of ESAP the economy has actually shown some enhanced resilience. To drive the point home Table 7 shows real GDP growth rates of Lesotho and South Africa for the period 1985-92. Even over 1990-92 period when South African real GDP experienced negative growth rates, Lesotho's real growth rate remained positive.

7. SOCIAL SERVICES AND SAFETY NETS:

A good ESAP should, *inter alia*, ensure that social services are at least maintained and preferably improved. Vulnerable social groups are also to be protected. Safety nets should be put in place. At the beginning Lesotho ESAP did not put much emphasis on these matters. Perhaps it is because, as pointed out earlier, preparation of the programme was hurried. Also possibly the international pressure that IMF sponsored ESAPs assume a "Human Face" had not yet yielded results. It was not until 1989/90 that a more focused attention was paid to the social aspects of ESAP in Lesotho and perhaps elsewhere.

Attempts to provide relief to vulnerable social groups took different forms. Personal income tax threshold was raised from about Maloti 1300 of annual income to Maloti 4020 for single person and M6000 for joint assessment in April 1990. In 1991 (April) it was raised further to M5088 for a single person to M7068 for joint assessment. Further raising of the threshold is possible. Tax deductible personal and dependents allowances were revised upwards. Basic commodities were exempted from the general sales tax (GST). They included unprocessed food items (raw food items), medicine manufactured in Lesotho, textbooks and farming implements used in subsistence farming. This exemption was lifted in October 1991 but was replaced by a lower blanket GST rate of 10 instead of 13 per cent. This facilitated administration while providing relief to low income households. Further personal income tax relief is possible (by way of adjustment of rates).

Government expenditure on social services such as health, education, social welfare and others, ought to increase in real terms. Other things being equal, implementation of this approach within the context of ESAP should bring about an increasing share of such social services in the Government budget. Some measure of success began to be manifested in 1990/91 fiscal year. The share of community and social services in the recurrent government expenditure rose from 36.4 per cent in 1990/91 to 38.1 per cent in 1991/92 then to 40.8 per cent in 1992/93 (Table 16). The actual impact of this favourable allocation will depend on the effectiveness of the implementation machinery in the public sector.

The Government set aside a Fund to be used for relief of the vulnerable groups for 1991/92 fiscal year. Bureaucrats and technocrats were unable to work out a scheme timeously to use this Fund. It remained virtually unspent. For 1992/93 collaboration with non-Governmental organisations (NGOs) in the effective use of this Fund was resorted to. Because of the drought in 1992 the increased Fund got used very quickly. More should be voted for this purpose. Efficient machinery to handle the task should be put in place.

8. OBSERVATIONS AND LESSONS FROM THE EXPERIENCE OF LESOTHO WITH E.S.A.P.:

Lesotho's experience with E.S.A.P. has either shed new light altogether about some points or has served to refute or even to confirm and to re-emphasize other points raised elsewhere in the avalanche of literature on this topical issue. The following lessons were derived not just from the specific case of Lesotho but from the experience of other countries s well:

Improved economic management tends to make even small, open and dependent economies, such as that of Lesotho, more resilient to internal and external shocks. What more of stronger economies!

Lesotho authorities identified that a macro-economic problem was developing, relatively early. A comparatively quick reaction saved Lesotho from the agony of heavy penalty usually paid by countries which delay in redressing the situation. Often the longer the problem is allowed to gain ground, the higher the burden of rectification will be.

The level of commitment to ESAP by the authorities was very high in the case of Lesotho. That is the key to success. Without genuine commitment at the political and policy level, ESAP would tend to stand little chance of success.

While recognition of the problem and the reaction to it were timeous, education of public servants and other key players in the private sector about ESAP was very late in coming, unenthusiastic and superficial. It was also not well coordinated.

Education of the general public was wanting. ESAP remained unexplained and therefore misunderstood to many and remains so even at this point. Yet full cooperation can only be successfully elicited if all participants appreciated the rationale, objectives and the mode of operation of the programme. It is with full cooperation by all participants that chances of success would tend to be enhanced. Moral suasion can be successfully applied not only in the monetary sector where it is traditionally applied, but in other sectors of the economy as well, where cooperation is required. There should b continuing dialogue between the public sector (that is, public officials) and the community and interest groups' leaders.

Successful changes to structures and institutions which are deeply rooted in the society's tradition and culture require a period longer than that usually allocated under SAF and ESAF supported programmes, to effect. It is impractical and politically insensitive to expect from a traditional society in a developing country as rapid acceptance of a fundamental change as is possible in developed industrial countries. The pace of change is simply different no matter how noble the cause may be. In the case of Lesotho this would refer to land reform, for instance. The land tenure system is entrenched in tradition.

In the case of Lesotho the social dimension of the programme has not been strong. Safety nets meant to protect vulnerable social groups featured rather late in the programme. It came as if it was an after-thought and has been conducted as if it is an appendage instead of being an integral part of the programme as it should be. Administration of this aspect of the programme left much to be desired.

Fiscal discipline in simple economies such as that of Lesothos, where the share of government activity in the economy is still very large, plays the key role in the stabilisation effort. Once there is resolute discipline in fiscal affairs, all else seem to easily fall into place. That is why unquestionable commitment by authorities is so important for ESAP to succeed.

If all stabilisation policies, namely fiscal, monetary and incomes, pull in the same direction and in harmony, then economic stabilisation endeavour becomes less tedious. This turned out to be the case in Lesotho. If, as is sometimes the case elsewhere, monetary policy is made to carry full weight alone while fiscal policy pulls in the opposite direction, then harsh measures have to be adopted. Stabilisation process becomes much more strenuous than it ought to be. In Lesotho these policies were in harmony.

Under conditions of a common monetary area, coupled with openness under customs union arrangements, the effectiveness of monetary policy is somewhat moderated. Desirable results can still be yielded, however, if skillfully formulated and applied.

One of the reasons why Lesotho was unable to curb inflation effectively is because it is also partially imported. The open nature of the economy, with the sourcing of imports from neighbouring countries under customs union and common monetary area arrangements, account for it. This underlines the need for the regional approach to ESAP. There should be regional coordination. This is popularly known as the regional dimension of ESAP.

In addition ESAP policies should not be in conflict with the process of economic integration through regional groupings. In formulating ESAP policies such endeavours should be borne in mind and accommodated. For instance Lesotho, besides being a member of SACU and CMA, is also a member of groups in formative stages such as SADC and PTA.

Ideally ESAP should operate within the framework of a national development plan. That gives a definite direction. In the case of Lesotho there was no functional development plan in place during both SAF and ESAF supported ESAPs.

ESAPs supported by Brettonwoods institutions through SAF and ESAF tend to emphasize financial performance. Actual fundamental structural changes are not equally concentrated upon. For sustainability structural improvements are of paramount importance. Such programmes also tend to confine themselves to the formal sector. Yet in much of Africa large populations are still supported by the rural and informal sectors. These sectors deserve special attention as well. A good ESAP should be comprehensive and development oriented.

No matter how good adopted policies may be at the political/policy level, if the government implementation machinery is weak, results will be disappointing. Executing machinery must be strong and efficient. Adequate administrative capacity to cope well with the rigours of structural adjustment is imperative. Lesotho's administrative machinery was fairly good but could have been better.

Good habits of proper economic management which are usually acquired during ESAP in successful cases need to be entrenched. Fiscal discipline in particular must be maintained and improved upon long after ESAPs. In that manner chances of a relapse will be obviated. There is, therefore, need for a successor programme to ESAF in order to enhance the chances of sustained proper economic management, *inter alia*.

Over the years there seems to have developed a convergence of ideas regarding approach to ESAPs between the authorities of economic re-structuring countries and the IMF. This includes the pace of reform, political sensitivity of certain policies and the importance of the social dimension of ESAPs. The need to change unworkable policies (which had earlier been adopted in good faith but without adequate scrutiny) is now mutually recognised and accepted. Unique circumstances in each country are now identified and accommodated.

Lesotho never really had tight controls of any type in the economy, comparatively speaking. Experience elsewhere has shown that excessive controls are an unnecessary nuisance. They may, at best, work very temporarily. After a little while ways to circumvent them are usually devised and used. Controls often merely represent diversion of attention to dealing with symptoms, away from dealing with the core problem(s). Focus should be on solving the problem(s).

A good ESAP will be effective if there is *punctual* and *full* application of policy measures and in a proper way. Policies are usually based on specific parameters. Such parameters are not fixed. They are mobile. Policy measures should take effect before parameters on which they were based change. Half measures are also ineffective. Full dosage should be applied for useful results. Proper sequence in the application of policy measures is also very important. Decisiveness is imperative in economic restructuring.

There is a general tendency to associate economic structural adjustment with the IMF. Yet economies can still be structured under home grown programmes without the Brettonwoods institutions. There is also another general tendency to regard ESAPs as the sole concern of countries with heavy external debt or which are facing other severe economic problems. Actually such countries are those that resorted to ESAP rather late and are already grappling for survival. Ideally ESAP should be part and parcel of the development process. Authorities should continually assist the economy to adjust to ever changing circumstances so that it can cope and therefore maximise its potential to grow and develop.

Many of the points raised are not at all new. Some have been raised before in the massive literature covering this topical issue. The experience of Lesotho merely served to re-affirm their validity.

CONCLUSION:

The experience of Lesotho with the economic structural adjustment pogramme has served to show that such programmes yield results, albeit measured, even in a case of a very small, open, dependent and still developing economy. Macro-economic indicators at the end of penultimate year of ESAF (1992/93) portray a fairly healthy (that is stable) economy amidst unfavourable international economic climate starting with a deep recession in neighbouring South Africa, and then general economic slowdown globally. The stage has been set for sound and hopefully sustained economic growth.

Table 1

GROSS DOMESTIC PRODUCT 1991
(in Millions United States Dollars)

	BOTSWANA	LESOTHO	SOUTH AFRICA	SWAZILAND
CURRENT PRICES	3,484.0	584.0	102,114.0	963.1
CONSTANT PRICES	1,969.0	169.0	51,563.0	493.5

Sources: Bank of Botswana
Central Bank of Lesotho
Reserve Bank of South Africa
Central Bank of Swaziland

Notes: For GDP constant prices
Botswana (1985/86 = 100)
Lesotho (1980= 100)
South Africa (1985 = 100)
Swaziland (1985 = 100)

Table 2

CONTRIBUTION TO THE GROSS DOMESTIC PRODUCT
BY SECTOR IN PERCENTAGES

	1987	1988	1989	1990	1991	1992*
Primary Sectors	18.8	21.1	20.9	19.6	14.4	9.8
Agriculture	18.2	20.8	19.6	18.9	13.8	9.3
Mining and Quarying	0.6	0.3	1.2	0.7	0.5	0.5
Secondary Sector:	26.9	28.2	32.6	33.5	35.7	38.4
Manufacturing	13.6	14.4	14.5	13.1	14.4	15.0
Construction	12.5	12.8	17.2	19.6	20.5	21.5
Electricity and Water	0.8	1.0	0.9	0.8	0.9	1.9
Tertiary Sector:	54.3	50.6	46.5	46.9	49.9	51.7

Source: Bureau of Statistics, Maseru, Lesotho

* Preliminary Estimates

Table 3

FISCAL DEFICIT AS PER CENT OF GDP AND GNP (1983/84 – 1991/92)

	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89	1989/90	1990/91	1991/92	1992/93*
Fiscal Deficit as % of GDP	(6.4)	(4.0)	(11.9)	(13.6)	(19.5)	(16.6)	(7.7)	(0.9)	(0.5)	0.4
Fiscal Deficit as % of GNP	(3.1)	(2.0)	(6.1)	(6.9)	(10.3)	(9.2)	(4.4)	(0.5)	(0.3)	0.2

Sources: Central Bank of Lesotho

* Preliminary actuals

Table 4

GOVERNMENT FINANCE: CAPITAL EXPENDITURE AS A RATIO TO TOTAL GOVERNMENT EXPENDITURE

%

1985/86	1986/87	1987/88	1988/89	1989/90	1990/01	1991/92	1992/93*
31 2	29.1	42.0	40.6	44.1	45.0	36.4	35.0

Source: Central Bank of Lesotho

* Preliminary Estimates

Table 5

FIXED CAPITAL FORMATION

	1985	1986	1987	1988	1989	1990	1991	1992*
As % of GDP	43.0	33.7	33 7	39.9	53.0	63.4	63.4	66.6
As % of GNP	23.2	18.8	18.7	22.7	33.0	39.9	41.2	45 0

Source: Central Bank of Lesotho

* Preliminary Estimates

Table 6

GROSS NATIONAL SAVINGS

	1985	1986	1987	1988	1989	1990	1991	1992*
As % of GNP	24.0	22.3	22.1	18.9	34.7	45.3	45.3	51.5
As % of GDP	46.5	42.9	42.9	34.3	59.5	78.4	78.7	85.4

Source: Central Bank of Lesotho

* Preliminary Estimates

Table 7

REAL GROSS DOMESTIC PRODUCT GROWTH RATE (1980 = 100) 1985–1992

	1985	1986	1987	1988	1989	1990	1991	1992*
Lesotho	3.5	2.0	5.1	12.9	11.8	5.0	0.9	2.1
South Africa	(1.2)	0.0	2.1	4.2	2.3	(0.5) (0.5)*	(0.4) (0.5)*	(2.4) (2 0)*

Source: Central Bank of Lesotho
South African Reserve Bank, Quarterly Bulletin

NOTE. * Data on South Africa provided by Financial Mail, April 2nd, 1993, p. 20

Table 8

INFLATION RATE: AVERAGE ANNUAL CHANGE ON CONSUMER PRICE INDEX

%

	1985	1986	1987	1988	1989	1990	1991	1992*
Lesotho	13.3	18 0	11.8	11.4	14.9	11.5	17.9	17.0
South Africa	16.2	18.4	16.1	12.7	14.9	14.4	15.2	14.0

Source: Bureau of Statistics, Maseru, Lesotho
South African Reserve Bank, Quarterly Bulletin

NOTES: 1. (January and April and July and October)/4
2. (March and June and September and December)/4

Table 9a

DEBT SERVICE RATIO
(1985–1992)

	1986 %	1987 %	1988 %	1989 %	1990 %	1991 %	1992* %
Danger Point	25	25	25	25	25	25	25
Debt Service Ratio	4.2	3.5	3.2	4.7	3.8	4.2	4.4

Source: Central Bank of Lesotho

* Preliminary Estimates

Table 9b

EXTERNAL DEBT AS PERCENTAGE OF GNP
(1985–1992)

1985	1986	1987	1988	1989	1990	1991	1992*
38.0	32.3	30.7	34.3	36.2	35.5	34.5	35 2

Source: Central Bank of Lesotho

* Preliminary Estimates

Table 9c

EXTERNAL CURRENT ACCOUNT BALANCE AS PERCENTAGE OF GNP (1985–1992)

1985	1986	1987	1988	1989	1990	1991	1992*
1.5	(1.8)	(1 3)	(8.3)	(2.8)	1.5	(1.0)	4.3

Source· Central Bank of Lesotho

* Preliminary Estimates

Table 10

OFFICIAL RESERVES (IN WEEKS OF IMPORT REQUIREMENT) (1985–1992)

	1988	1989	1990	1991	1992*
Standard Desirable Number of Weeks	12	12	12	12	12
Actual Weeks of Imports (December of Each Year)	8.0	7.0	10.3	10.5	13.5

Source: Central Bank of Lesotho
* Preliminary Estimates (because of import figure)

NOTE: IMF Mission team puts 10 weeks for 1991/92, 11.7 weeks for 1992/93

Table 11

SHARES OF NET DOMESTIC CREDIT BETWEEN GOVERNMENT AND THE PRIVATE SECTOR (1987-1992) IN PERCENT

	March 87	March 88	March 89	March 90	March 91	March 92
Government	56.2	60.0	60.8	56.7	7 3	6.8
Private Sector	43.8	40.0	39.2	43.3	92.7	93.2
	100	100	100	100	100	100

Source: Central Bank of Lesotho

NOTE Private Sector in this case includes households, business enterprises and statutory bodies (i.e. parastatals)

Table 12

GROWTH RATE OF NET DOMESTIC CREDIT TO GOVERNMENT AND THE PRIVATE SECTOR (1988-1993)

	March 88	March 89	March 90	March 91	March 92	March 93
Government (%)	55.1	44.2	(2.0)	(90.5)	(1.1)	(1,043 8)
Private Sector (%)	32.4	39.9	15.8	57.2	7.8	9.1

Source: Central Bank of Lesotho

NOTE: Private Sector in this case includes households, business enterprises and statutory bodies (i.e. parastatals)

Table 13

GROWTH RATE OF NET DOMESTIC CREDIT TO THE PRIVATE BUSINESS ENTERPRISES (1988–1993)

March 88	March 89	March 90	March 91	March 92	March 93
(30 1)	39.5	84.7	8.9	43.2	28 8

Source: Central Bank of Lesotho

Table 14

AVERAGE ANNUAL GROWTH RATE OF THE FINANCIAL SECTOR 1985–87 AND 1988–1992 (IN PERCENT)

	1985–87 %	1988–1992 %
Deposits	14	14
Assets	10	14
Capital	6	16
Net Loans	15	17

Source Central Bank of Lesotho

NOTE: Financial Sector in this case refers to all deposit taking institutions in Lesotho except the Central Bank of Lesotho

Table 15

AVERAGE ANNUAL GROWTH RATE OF THE CENTRAL BANK OF LESOTHO (IN PERCENT)

	1985–87 %	1988–92 %
Deposits	24.0	48.0
Assets	21.0	28.0
Capital & Reserve	(5.0)	38.0

Source: Central Bank of Lesotho

Table 16

SUMMARY OF RECURRENT EXPENDITURE BY FUNCTIONS OF GOVERNMENT (IN PER CENT) 1985/86 – 1992/93

	1985/86 %	1986/87 %	1987/88 %	1988/89 %	1989/90 %	1990/91 %	1991/92* %	1992/93** %
General Government Services	33.0	37.6	37.2	34.5	31.2	32.2	33.4	35.1
Community & Social Services	35.6	35.1	31.8	33.1	30.9	36.4	38.1	40.8
Economic Services	13.6	13.1	13.7	16.2	12.0	11.8	13.7	13.5
Unclassified Expenditure	17.8	14.2	17.3	16.2	25.9	19.6	14.8	10.6
Total Expenditure	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Sources: Ministry of Finance

* Preliminary actuals

** Projections

ECONOMIC ADJUSTMENT, POLICY PERFORMANCE AND DEVELOPMENT IN TANZANIA

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ECONOMIC ADJUSTMENT, POLICY PERFORMANCE AND DEVELOPMENT IN TANZANIA

By

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INTRODUCTION

Tanzania, like many other African countries, is still in the midst of a far-reaching economic crisis that is unprecedented since the country gained independence in 1961. The economic crisis is characterized by low growth rates, unsustainable balance of payment deficits, unserviceable foreign debt, fiscal imbalances, high inflation rates and high dependency on foreign aid to finance both imports and the government deficit

Since 1986 the government adopted an IMF World Bank supported Economic Recovery Programme (ERP). Economic performance since the adoption of ERP has only been moderately successful. The average annual growth rate has increased from less than 1 percent during 1980-85 to 4 percent during 1986-90. The inflation rate has decreased from 33 percent in 1986 to 21 percent in 1991. The balance of payments position is still precarious as official export receipts have not recorded significant growth rates It can be argued that improved economic performance is largely explained by better weather conditions and improved external resource inflows The economy has yet to move on to a self sustaining growth trajectory

The objective of this paper is to analyse stabilization and adjustment policies undertaken by Tanzania and their impact on economic performance. After this introduction part II discusses a historical background to the economic crisis focussing on development policies adopted and their impact on economic performance. Part III of the paper discusses adjustment efforts and policies adopted to resolve the economic crisis Part IV critically analyses the experience of policy formulation, implementation and impact and suggests how to improve policy packages, sequencing and implementation to improve economic performance into a self-sustaining high growth trajectory with poverty elimination being one of the central goals

II Historical Background

When Tanganyika (Tanzania mainland) attained political independence in 1961, economic policies were largely derived from the World Bank Report entitled "The Economic Development of

Tanganyika" Stable macroeconomic policies were pursued by continuing with the East African Currency Board system in which

the East African shilling was backed by sterling assets Only an insignificant amount of fiduciary issue was permitted Commercial banks were subsidiaries of large British banks mainly involved in the short term financing of international trade. Under this arrangement, a balance of payments crisis in the form of an existence of an effective demand for imports that could not be fulfilled because of lack of foreign exchange (pound sterling) could not happen Without an independent central bank, the government could not finance its deficits by printing money no earn any seigniorage

In the first six years of independence (1961-67) economic growth was moderately high averaging 5 5 percent and was largely caused by a high growth rate of production of primary exports particularly cotton, coffee, cashewnuts, tea and tobacco Manufactured value added grew at over 12 percent per year as a result of early import substituting industrialization

The first five-year development plan focussed on improvement in infrastructure particularly surface communication The agricultural policy that was emphasised was the so called transformation approach which attempted to create modern farmers out of peasants by establishing new settlement schemes where participants were to be supervised to become modern farmer The settlement schemes were largely a failure and growth of agricultural exports continued as a result of increased

production outside new schemes (Coulson,1982) The growth of production of agricultural exports that started in the 1950s can largely be explained by vent for surplus theory Surplus labour and land were utilised to grow export crops, the money income earned was used to purchase manufactured goods. The growth of agricultural production was facilitated by the existence of marketing channels for consumer goods and agricultural produce

The economic policies adopted in the first six years of independence can be characterised as moderately private-sector friendly The *Arusha Declaration* of 1967 initiated a series of policy changes whose aim was to establish a state-controlled socialist economy The Government nationalised the commanding and not so commanding heights of the economy It discouraged development of private sector enterprises and public sector employees in the civil service and parastatal enterprises were prohibited from investing
or managing capitalistic enterprises. In the agricultural sector private farming was generally discouraged in favour of

cooperative and communal agriculture. Even though communal farming never became a significant source of agricultural production, government policies continued to discourage the development of private farming Agricultural marketing of export crops and cereals wasunder the monopoly of state-sponsored cooperatives and marketing boards Overtime, the economy became increasingly controlled by the state,and private enterprise and enterpreneurship particularly among the indigeneous people was discouraged

The main objective of the *Arusha Declaration* was to arrest the development of capitalism in Tanzania which it was believed would lead to the development of mainly two classes in society a few rich and a poor majority In retrospect it can be argued that in the 1960s Tanzania lost the opportunity of developing a market oriented economy based on small holder agricultural production that could have promoted growth with equitable income distribution and lay a foundation for a resource-based industrial development.

With the benefit of hind sight, the overall impact of post-*Arusha Declaration* policies was to discourage entrepreneurship. Private sector agriculture was discouraged by low producer prices and inefficiency of both the crop marketing system and the distribution of agricultural inputs and consumer goods. In the manufacturing sector, the state became the leading investor accounting for most of the investment in the 1970s and early 1980s Particularly after the adoption of the Basic Industry Strategy in 1975 (Skarstein and Wangwe 1987)

The economic control regime was extended to internal trade. Most basic "essential goods" were confined to state trading companies. The prices of most goods that were confined were controlled by the government. Tanzania never became a centrally planned economy like Eastern European economies or even Cuba Agriculture which continued to employ over 85 percent of the labour force continued to be in the private sector, however, state controls in agricultural trade and distribution of inputs hampered its progress The control regime promoted directly unproductive rent-seeking activities particularly in the 1980s when shortages became acute.

The overall impact of the control regime that was steadily established after the adoption of the *Arusha Declaration* is clearly shown by the steady decrease in the volume of exports in general and agricultural exports in particular (Table AI)

The growth rate of GDP decreased overtime Sectors contributing to material production experienced the worst performance and only public administration which includes the provision of social services by the government recorded high growth rates (Table I)

The provision of social services particularly primary education, water supply and health care was a cornerstone of policies adopted after the *Arusha Declaration*. The World Bank (1977) criticised the adoption of Universal Primary Education policy on budgetary constraint basis The problem facing Tanzania was not desirability of providing social services but rather the adoption of a sustainable system of financing these social services.The slow growth of the economy hindered the maintenance of the infrastructure and the financing of recurrent expenditure.

The economic crisis facing Tanzania was initiated by external shocks The first major shock occured in 1973 when a combination of the oil price increase and drought caused a huge balance of payments deficit in 1974 and 1975 (Green, Rwegasira and Van Arkadie,1980) The response of the government to this crisis was in the form of attempting to achieve food self-sufficiency and mobilising external assistance The crisis was resolved by a commodity boom of 1976-77 particularly the increase in world coffee prices.

The coffee boom and the improvement in the balance of payments was short lived. The war with Iddi Amin Dada of Uganda in late 1978 and the second oil price hike in early 1979 initiated the severest balance of payments crisis that have persisted to the present External shocks initiated the balance of payment crisis but its persistence and inability to effectively respond to the crisis is explained by an institutional set up and policy framework that discouraged production for export and efficient import substitution. The purchasing power of exports that decreased by 7 percent per annum between 1970 and 1990 is explained mainly by the fall of the volume of exportsrather than deterioration of the terms of trade (Lipumba,1988,Ndulu and Lipumba,1990).

III. Stabilization and Adjustment Policies

Tanzania entered the 1980s facing a severe balance of payments crisis with a large accumulation of balance of payments arrears relative to export earnings and an unserviceable external debt (Table A2) The government budget recorded large deficits Parastatal enterprises particularly agricultural marketing boards made losses that were financed by borrowing from the banking system The financing of the central Government deficit and the borrowing of parastatal enterprises from the banking system led to high growth rates of money supply which fueled inflation reaching an average of over 30 percent in the first half of the 1980s

The economic crisis was explained by two competing theories. Among some leading politicians the crisis was largely seen as caused by external shocks particularly oil price increses and the deterioration of the terms of trade, the cost of the war with Iddi Amin of Uganda, the breakdown of the East African Community that used to jointly provide transport and communication services to East African countries and poor weather conditions. Most external aid agencies particularly the World Bank and the IMF argued that the main causes of the economic crisis in Tanzania were internal including an overvalued exchange rate, low producer prices,an inefficient and monopolistic agricultural marketing system and excessive price controls

The first major adjustment effort involved reaching a two-year standby agreement with the International Monetary Fund in August 1980 involving a stabilization loan of SDR 186 million (USD 240 million) The conditionality of this arrangement did not involve any devaluation because the government was totally opposed to it and the then President of Tanzania had criticised the IMF for attempting to usurp the role of the Minister for Finance of Tanzania (Development Dialogue, 1980)

The standby arrangement had the usual quarterly credit targets as performance tests. The government was, however not convinced of the rationale and practicability of adhering to the credit targets. The credit ceilings were exceeded in the first quarter of the programme and the IMF cancelled the standby arrangement.

After the breakdown of the agreement with the IMF the government launched in 1981 a "National Economic Survival Plan" (NESP) whose objectives included an increase in agricultural production to attain food self sufficiency, reduce the foreign exchange constraint by increasing exports and the use of locally available raw materials, reduce inflation by reducing budget deficits and effectively controlling prices of essential goods, and to continue maintaining an egalitarian income distribution and the provision of primary education, health services and water supply to all. The implementation of NESP depended on administrative mobilization of goods for export and allocation of inputs and consumer goods. The administrative controls could not be sustained over a long period and led to widespread development of parallel markets for almost all goods under price control.

The World Bank attempted to mediate the disagreement between Tanzania and the IMF by appointing a "group of wisemen" The Tanzania Advisory Group to develop a "Structural Adjustment

Programme" that could be adopted by the government and supported by the World Bank and IMF. In 1982 the government adopted a Structural Adjustment Programme (SAP) whose aim was to correct the macroeconomic imbalances by improving balance of payments, reducing the fiscal deficits and the growth of money supply and hence controllig inflation.

The implementation of the three-year structural adjustment programme depended on the availability of the structural adjustment loan of USD 200 million a year from the World Bank and IMF. This external loan did not materialise largely because of disagreement on the magnitude of the required devaluation of the Tanzania shilling. The successful implementation of SAP was hampered by lack of adequate balance of payments support. The government increased nominal producer prices which did not lead to an increase in output because of severe transport bottlenecks, marketing inefficiencies of crop parastatals, and a shortage of consumer goods and production inputs.

The severe foreign exchange shortage reduced capacity utilization in manufacturing industries that contributed to shortages of most consumer goods. The administrative allocation of goods and the price control system were unable to prevent the widespread use of parallel markets for various goods. The government attemped to improve the allocation system by cracking down on the parallel market. The shortages were real and the crackdown worsened the shortages and led instead to increased prices because of the risk premium.

The economic collapse associated with the control regime led to a change in policy and cautious trade liberalization. In 1981 the Government permitted individuals with access to foreign exchange outside the official system to import "essential" consumer goods, spare parts, inputs and capital goods;and sell those goods at market-clearing prices. Furthermore, producer prices of major export crops were significantly increased, and the shilling was devalued by 25 percent in dollar terms. These measures were seen to be too little and too late by the World Bank and the IMF and hence no agreement for balance of payment support was concluded.

The trade liberalization measures of permitting "own-funded" imports significantly improved the availability of incentive goods and promoted agricultural production particularly of food crops. The removal of restrictions on imports was officially confined to a list of goods and intermadiate inputs considered as necessities for consumption or required in production. In practice however most goods could be imported. This led to a boom in importation of goods including frivolous and luxury goods but it also included intermediate imports and capital goods (Ndulu, 1988).

Far reaching economic reforms that started in 1981 were intensified in 1986 when the government became less averse to the adoption of market oriented economic policies including a large devaluation mainly because of an election of a pragmatic and a less ideologically inclined president. Economic reforms adopted under the "Economic Recovery Programme" (ERP) included a large devaluation and an adoption of a dirty crawling peg, large increases in nominal interest rates, liberalization of grain marketing, increase in producer prices of agricultural exports and the limiting of the financing of the government deficit by borrowing from the banking system.

Throughout the 1980s it was clear that the Tanzanian economy was facing major macro-economic imbalances including unsustainable balance of payment deficits, large fiscal deficits, large losses of parastatal enterprises that increased public sector deficit broadly defined, high rates of inflation and decreasing domestic saving rate. The debate in the early 1980s focussed more on whether the imbalances were caused by domestic policy mistakes or external shocks and the relevance of "main stream" macroeconomic instrument such as devaluation, monetary restraints through credit control and increases in interest rates in solving these macroeconomic imbalances (Green et al. 1981, Green 1983) The internal discussion of these policy measures particularly in these Annual Economic Policy Workshops, pressure from the Bretton Woods institutions and aid agencies and a transition towards a second-phase Government led to the adoption of policy instruments that had been completely dismissed as unworkable in the early 1980s (Lipumba et al eds 1984)

For purposes of discussion, I have divided policy measures taken into two related groups Stabilization policies and adjustment policies Stabilization policies have been derived from mainstream macroeconomics of "fine tuning" the economy to attain internal and external balances. Within developing countries, these policies focus on improving the balance of payments and reducing inflation In developed capitalist economies, the stabilization policies are supposed to work within a short period but in most developing countries the impact of these policies in the short run have proved to be minimal The stabilization policies that have been adopted in Tanzania include.

(a) Exchange Rate Adjustment

In order to reduce the external imbalance and the overall foreign exchange shortage, the shilling has been devalued from Shs 16 to Shs 230 per US dollar between March 1986 and June 1991 In real terms, using simple purchasing power parity, the real exchange rate appreciated by 60 percent between 1966 and 1985, and by 1988 the exchange rate adjustments that had taken place corrected the past overvaluation (Lipumba, 1991). Even when the fundamental determinant of appropriate exchange rate including terms of trade, real world market interest rate and relative productivity increases, the real exchange rate in June 1991 is quite close to the real rate of 1966 (Bank of Tanzania, 1991) Real exchange rate computations are subject to a great controversy in terms of appropriate base period, weights to be used, and price indices For Tanzania they should be taken as rough indicators of measures of overvaluation

Despite significant real depreciation of the exchange rate, aggregate export performance is still unimpressive Officially recorded merchandise exports have increased from US $427 in 1990 which is still far below the US $553.7 attained in 1981 The aggregate empirical evidence may be used to dismiss the efficacy of devaluation in improving export performance It should be noted that for devaluation to improve export performance, you require an effective pass through of foreign prices into domestic prices and a good infrastructure and particularly a reasonably working transport system Non-traditional exports that have an effective pass through have increased many folds though from a small base "Own-funded" imports are also largely finaned by exports that are not officially recorded The response of exports to increased profitability is much larger than indicated by recorded merchandise exports In addition traditional export crops continue to face marketing problems that constrain the effective pass through. A depreciation of the real exchange rate can be ar invaluable stimulant to exports if it is accompanied by improved infrastructure and efficient marketing organization. Exports through formal channels are constrained by a cumbersome administrative structure that requires export permits by sectoralministries, export licensing by the Board of External Trade, and export registration by the central bank apart from possession of a business license issued by the Ministry of Industry and Trade that has to be issued every year subject to an income tax clearance

A reform of the administrative structure that restricts an establishment of private business in general and exporting enterprises in particular is necessary for promoting exports. Apart from improving the regulatory framework and physical infrastructure, the development of an export servicing sector is necessary. The functioning of the existing Board of External Trade has not facilitated and promoted Tanzania exports.

Despite a large adjustment of the exchange rate the trade regime is still characterised by a multiple-exchange rate. Imports through the official system which include resources of the central bank and the "Open General License" (OGL,funds that are mainly financed by donor agencies) are sold at the official exchange rate Access to the central bank's foreign exchange is restricted to financing petroleum imports some medical supplies and other imports by Government The OGL funds are used to finance imports that are not in the negative list Access to OGL funds has not been automatic because of lack of adequate funds mainly due to delays in disbursements by donor agencies particularly the World Bank when they perceive that their conditionalities have not been met.

Private sector funded imports are largely financed by illegal exports The government has since April 1992 legalised private sector transanctions in foreign exchange by permitting the establishment of Bureau de Change that buy and sell foreign exchange at freely determined exchange rates. The exchange rate premium of the bureau rate over the official rate is about 20 percent The Government's medium policy objective is to unify the foreign exchange market in order to achieve efficient resource allocation where both users and earners of foreign exchange face the same price

The liberalization of the foreign exchange market has been criticised because it can be used as an easy channel for capital flight. The concern of capital outflow being detrimental to domestic investment and growth is widespread not only among the general public but also economists Controls on capital outflow through official channels are not always successful when the fundamental incentive structure and rules of the game are not conducive to promoting domestic investment If investors have confindence in the economic policies and the country has political stability and foreign exchange can easily be secured, the urge and incentives for capital flight may not be high An overvalued exchange rate, low real net returns to savings and investment, high inflation rates and uncertainty in proper rights and the rules of the game will encourage capital flight regardless of the presence or absence of official controls The main impact of the official controls particularly when the system has broken down is to redistribute little bit of income from those who export capital to those who police the control regime.

Promotion of foreign investment requires the presence of a two-way traffic As Prime Minister Mahathir bin Mohamed of Malaysia putit, "if you don't allow money to flow out it will not flow in"!'A liberal exchange control regime requires appropriate exchange rate policy to avoid overvaluation and prudent monetary policy to avoid both inflation and negative returns to financial saving and investment. The Tanzanian shilling is convertible in the parallel market. The Government realises that efficiency and promotion of economic growth requires it to be also convertible in the official market at least for current account transactions.

(b) Monetary Restraint and Interest Rate Policy

In order to reduce inflation and mobilise domestic financial savings the ERP adopted, in theory, the policy objective of reducing the growth of money supply and the expansion of the domestic credit. The objective of reducing growth of money supply was not achieved as the growth rate of M2 ramained around 30-40 percent compared to the target rate of 15-20 percent. The main cause of the persistent high growth rate of money supply was the large unpaid loans to cooperative unions and marketing boards to finance crop

purchases. The problems of agricultural marketing that will be discussed later have been the main cause of the growth of money supply, inflation and the overvaluation of the shilling. Improving efficiency in agricultural marketing and reducing losses of agricultural cooperatives and marketing boards will have a positive macroeconomic impact. In 1992 however, a shortfall in government revenue and government borrowing from the banking system to cover the deficit caused money supply to grow by over 40 percent.

Nominal interest rates on savings deposits were increased from 10 percent in 1986 to 26 percent in 1989. The maximum lending rates were also increased from 16 percent in 1986 to 31 percent in 1989. By 1991 real interest rates on savings deposits and lending rates were positive. The increase in the growth of money supply mainly because of the lending to cooperatives and marketing boards was not based on commercial criterion. Given the institutional set up, interest rates could not be used to control aggregate credit expansion. It could actually worsen the growth of money supply if unpaid interest is considered as income receivable and converted into loans. The sequencing of reforms was clearly wrong. Commercial banks must operate commercially for interest rate policy to be an effective restraint to monetary expansion. In addition, positive

real interest rates have to be achieved by reducing the rate of inflation rather than by increasing nominal interest rates.

(c) Reducing Government Deficit

The overall budget deficit has remained very high. As a percentage of GDP the overall budget deficit has increased from 10 percent in 1986 to approximately 14 percent in 1990. Until the current financial year 1992/93; the financing of the government deficit was less dependent on borrowing from the banking system, instead it is increasingly dependent on external loans and grants particularly import support counterpart revenue. Since the adoption of ERP, external funds directly financed around 30 percent of the central government total expenditure. Even recurrent government expenditure is increasingly dependent on import support counterpart funds.

The high dependence of external financing of the budget deficit is not sustainable in the medium and long run. The 1992/93 Government budget removed taxes on intermediate inputs and capital goods with the expectation of increasing revenue by reducing tax exemption and improving tax collection. Contrary to expectations, tax collection did not improve and the government is facing a large deficit. Tax evasion is still a major problem. Imports financed by private sources of foreign exchange are usually under-invoiced to avoid custom and sales taxes. Private enterprises understate their profits and the informal sector generally does not pay income taxes. Improvement in tax administration is necessary in order to improve government finances.

The government budget has a major structural weakness which will not be resolved by increasing tax revenue. Government expenditure is spread too thinly across many areas to the extent that no programme is effectively being implemented. This requires the evaluation of what role the government should be playing in the Tanzanian economy.

(d) Trade liberalization

In Tanzania trade liberalization took the form of permitting "own-funded" imports that were sold at market-clearing prices. It was a unique policy instrument that was adopted without any external influence in order to reduce the serious shortages of essential goods and inputs that were common throughout the economy. When introduced, this policy was considered to be a temporary measure applicable to an approved list of goods. In practice, largely due to the increasing "softness" of the state, almost any good could be imported under the own-funded import system. This policy has been most successful in reducing shortages of essential goods and even increasing the supply of "frivolous" goods.

Due to effective evasion of import duties and sales taxes most domestic industries face not only stiff competition but also negative protection because they import their inputs through official channels and have to pay import duties for their inputs. Manufacturing industries such as those producing textiles and garments have been petitioning for some form of protection from unfair competition and dumping from overseas. Given the existing high cost of living it will be a major economic and political mistake not to continue with the own-funded import regime. To protect domestic industry we have to depend on the use of tariffs and the removal of tax evasion through the improvement of tax administration.

STRUCTURAL ADJUSTMENT AND INSTITUTIONAL REFORMS

The experience of real existing socialism of Eastern Europe and the former Soviet Union has generally shown that a market oriented economy is indispensable for sustained economic development and social progress (Kornai, 1990). The market economy however, cannot function without an effective government that provides "public goods" that cannot be provided by the private sector due to the existence of market failures and externalities. The public goods that should be provided by the government include basic infrastructure such as roads, railways, telecommunications (new technologies have reduced and are reducing the "publicness" of this service), power, and water supply. Direct or indirect government participation in the provision of these goods and services is common even in capitalist economies.

In a democratic society, citizens have fundamental rights that have to be guaranteed by the government if it claims to represent its citizens. These rights include basic education, basic health and social security. Basic educationa and health have positive externalities and are likely to be under-supplied by a private sector in a market economy. Governments have a role to intervene in order to guarantee, but not necessarily directly pay for, adequate provision of these services. An important public good that the government has to provide is the rules of the game including incentives, private property laws, and contract laws under which the private sector will operate.

In main-stream public finance it used to be argued that other than the provision of public goods, market economies will produce outcomes that are Pareto efficient in the sense that no one can be made better off without worsening the position of another individual. Apart from ignoring the original problem of political economy a la Ricardo i.e. income distribution, in the presence of imperfect information, incomplete risk markets, and incomplete futures markets, market economies are essentially never constrained Pareto-efficient and there is a potential role

for government intervention, which however, does not necessarily mean government ownership (Stiglitz, 1990). Problems of risk and lack of information that affect the private sector equally affect the government. "Government failure" may be as much of a problem as "market failure" and therefore there is no guarantee of government intervention solving the problems of imperfect information, incomplete futures and risk markets.

The priority area of government intervention and participation are: establishing a just legal framework under which households and private firms will have incentives to produce goods and services, establishing and maintaining physical and social infrastructure, and provision of social security. The government that is not successful in providing these public goods is not likely to succeed in directly producing "private" goods. The history of successful countries in economic development shows a very active role of the government in promoting economic development, not only by providing public goods but also directly participating in the establishment of basic industries. It should, however be noted that, state intervention in direct production took place when these govenments had the capacity to develop and maintain physical infrastructure and promote basic education, technical training and research.

The basic problem facing the government in Tanzania is

that it has not been able to provide and maintain basic physical and social infrastructure and establish an environment that is conducive to promoting economic initiative and enterprise. The state is overextended, attempting to do too many things without clear priorities resulting in poor delivery of public services and poor performance of public commercial enterprises. The main objective of structural adjustment and institutional reform is to create a conducive environment for households, private and public enterprises to efficiently produce goods and services and to promote economic growth and social progress.

(i) Agricultural Marketing

Since independence the government has intervened in agricultural marketing. First, the government prohibited private traders, mainly Asian Tanzanians, in agricultural marketing and introduced and gave monopoly to agricultural marketing cooperatives throughout the country. Many cooperatives, particularly in regions that did not have previous cooperative experience performed badly In the mid-1970s the government abolished cooperatives including those that had grassroot support and were performing reasonably well. It introduced crop authorities that were supposed to provide extension services, research and marketing of some specific crops. The crop authorities became a burden to both peasants and the banking system. In 1984, cooperatives under the leadership of the ruling Party were introduced and the crop authorities became marketing boards responsible for exporting. The co-existence of marketing boards and cooperative unions resulted in double financing. Cooperatives borrowed to finance the purchase of crops from farmers and marketing boards borrowed to finance their purchases from cooperative unions. Neither cooperatives nor marketing boards paid back all of their loans In addition, some farmers were not paid for some of the crops they sold to cooperatives or marketing boards.

The thirty years of government intervention in agricultural marketing in the name of assisting peasants have not established an efficient agricultural marketing system in which inputs are distributed, crops purchased and peasants paid in time. The new legislation on cooperatives rightly intends to establish independent and grassroot-based primary cooperative societies. In regions with a tradition of grassroot cooperatives and where existing cooperatives have not performed too badly there is a good chance of success In regions where peasants have only sweat and tears to show from the performance of "their" cooperatives even the new legislation may not necessarily lead to the formation of efficient cooperatives.

The logical conclusion of the historical experience of agricultural marketing in Tanzania is to allow a competitive multiple channel marketing system. Cooperatives have to prove themselves in the market place by providing higher prices and better services than private traders. The members of the cooperatives and not the government should control these institutions. Both cooperative and private traders must be financially responsible and pay back their loans.

The introduction of private traders in agricultural marketing and processing of traditional exports is being resisted by marketing boards and cooperative unions because they want to protect their monopoly positions in agricultural marketing. There is also genuine concern that foreign exchange remittances to the Bank of Tanzania may be reduced if private traders are involved in the marketing of traditional exports. Most of the traditional exports are sold or can be sold in auctions and transparent tender system that are quoted in foreign exchange. It is thus possible to monitor all foreign exchange receipts

Despite problems of ideological nostalgia about cooperatives and Government marketing institutions, agricultural marketing liberalization is on track. Cooperatives will have to be cooperatives and not government agencies. They have to pay their loans and will not necessarily have automatic monopoly With respect to grains, trade has largely been liberalised and the National Milling Corporation (NMC) is expected to operate as a commercial milling company. Private traders have

been licensed to purchase cashewnuts from farmers. To increase the ginning capacity to handle increased cotton production, the private sector including independent cooperatives are expected to establish ginning companies. Once the liberalization process takes hold and farmers are promptly paid and receive better prices it becomes politically difficult to reverse the gains of liberalization

The agricultural potential of both food and export crops has not yet been fully exploited. Among traditional export crops, cotton, cashewnuts and the high quality mild arabica coffee can attain a growth rate of more than 5 percent per annum if input distribution and marketing problems are removed and known crop husbandry measures are practised. Non-traditional exports including pulses, oil seeds, fruits and vegetables can grow at even higher rates. If we have average good weather conditions, good policies that assure effective higher producer prices by having a competitive multiple channel marketing system, supportive infrastructure and extension services, and timely input distribution, Tanzania can experience an agricultural production boom.

(ii) Government Expenditure and Civil Service Reform

As noted earlier, government expenditure has not been effective because most programmes are under-funded. The policy of "distributing equally the small amount we have" has implied that roads have not been well maintained, education has deteriorated, health services are poor, investment projects are not completed and government employees have to moonlight, or seek and accept bribes in order to keep their sould and body together For senior officials including Government Ministers and Principal Secretaries, the incentives structure is such that it promotes excessive and in many cases unnecessary travelling.

The role of the government has to be redefined so as to focus on providing and maintaining physical infrastructure, assuming the provision of basic education and health services, maintaining law and order and a fair legal system, and provision of national security at a reasonable cost.

Given these basic objectives and the resources that are likely to be available to the government even after implementing a tax reform that aims at increasing government revenues without discouraging investment and promoting inefficiency, the government will not have a large surplus to invest in commercial activities that can be carried out by the private sector including independent cooperatives.

If the government gives priority to providing public goods then it will not have surpluses to invest in commercial enterprise, economic ministries will concentrate on policy analysis and design. These government ministries are likely to require fewer employees but of higher quality At present we have too many people in the civil service who are demoralised The restructuring of government expenditure and civil service should aim at increasing morale to government employees by offering better pay and well defined responsibilities.

The civil service reform necessarily implies the reduction of the role of the government in commercial activity. To raise salaries without increasing the budget deficit implies a reduction of the number of government employees A redeployment programme that offers new opportunities to public sector employees in the private sector is necessary in order to make both the parastatal sector and civil service reform politically feasible

(iii) Parastatal Sector Reform

Parastatal enterprises were instruments used to attain government control of the modern sector of the economy first by nationalising private companies and putting them under the control of parastatals and later on by channelling government investment through these institutions In the 1970s some departments in ministries providing non-commercial services were transformed into parastatal organizations.

The parastatal enterprises have not attained the objective of promoting growth and structural transformation and providing adequate financial resource to the government in the form of dividends Increasingly parastatal enterprises have been receiving subsidies from the central Government The causes of the poor performance of parastatal enterprises include inadequate capital, lack of foreign exchange, inappropriate technologies, lack of competent technical and management skills and multiple and sometimes conflicting objectives and government interference in their management

The on-going economic reforms have adversely affected parastatal enterprises. Devaluation has increased the parastatal debt burden in shilling terms. Furthermore, the high interest rates have increased their debt servicing burden, and own-funded import trade liberalization has increased competition for the domestic market. A number of parastatal enterprises are no longer commmercially viable or require a large injection of capital The government budget is in deficit and dependent on foreign capital inflow. The restructuring and consolidation of public enterprises is not an ideological question but a practical issue of salvaging whatever capital that remains in the non-viable enterprises and increasing efficiency in the remaining enterprises.

The parastatal sector reform is ideologically, politically and socially a sensitive issue because it involves closing down enterprises or selling them to private firms and invariably reducing the number of employees. The government can not avoid the restructuring and reform of the non-viable parastatal enterprises. The choice is between unplanned consumption of the existing capital stock until when the enterprises cease to exist or systematic restructuring and consolidation to salvage some of the investment for the national good.

Effective parastatal reform in Tanzania will necessarily involve some privatization simply because most of the existing commercial parastatals are under-capitalised and the government does not have the resources to invest in these parastatals to make them effective enterprises. The privatization of the enterprises faces not only political but also technical constraints. Given the absence of capital markets, there is no market valuation of these enterprises. In addition most enterprises have huge local and foreign debts. Most would be buyers will not want to inherit the debts of the enterprises particularly given the fact that for some enterprises, particularly those that have not been fully operative, the value of the enterprise may be lower than their debts.

The local effective demand for commercial enterprise may be limited to few wealthy businessmen within the Asian community. Open-ended privatization may imply the handing over of public enterprises to local Asian businessmen or foreign companies. In principle Asian Tanzanians should have similar rights like any other Tanzanians. Politically, it is in the interest of even the Asian businessmen to have a more cosmopolitan business community. It can be argued that if we had an indigeneous business community, the past excesses of nationalization including the nationalization of residential housing and butcheries would have been avoided. The parastatal sector reform should take into consideration the strengthening of the indigeneous entrepreneurs.

There is a danger of overemphasizing privatization and its problems and ignoring the challenge of creating a level playing ground for the promotion of new efficient enterprises. Economic growth will largely be generated by new investment rather than the misallocated investment of the past.

(iv) Financial Sector Reform

Well functioning financial markets are now well recognised to be central to the development process in which efficient capital allocation is necessary (McKinnon, 1973, Shaw, 1973; Fry, 1988). There is no doubt that the financial system in Tanzania is archaic and inefficient. Transaction costs through the National Bank of Commerce (NBC) are high. The NBC has not operated commercially partly due to government intervention and its monopoly position. A modern economy in need of promoting investment and encouraging private investment (local and foreign) requires an efficient financial system that can promote financial saving and allocate loanable funds to productive enterprises.

The "Report and Recommendations of the Presidential Commission of Enquiry into the Monetary and Banking System in Tanzania" clearly showed the need for financial sector restructuring in order to promote savings, investments and economic growth. The government has broadly adopted the recommendations of the Report and the Banking and Financial Institutions Act of 1991 aims at establishing a competitive financial system that will be independent and operating under sound commercial principles. Under the new (1991) banking legislation private financial institution can be established and the Bank of Tanzania will play an active supervisory role.

The existing commercial banks that have in the past not operated independently and commercially and thus accumulated a large share of non-performing assets in their portfolio are in the process of being restructured. Their balance sheets will be cleared and the Treasury will take over the non-performing assets and try to recover from the debtor enterprises the loans extended by the commercial banks.

Commercial banks will be independent to determine interest rates charged to its clients. The Bank of Tanzania will set the maximum lending rate. Commercial banks will set their own saving deposit rates provided the 12 month deposit rate is greater than the inflation rate. This flexibility is expected to allow financial institutions to operate commercially.

A successful implementation of the financial sector reform will permit the utilization of traditional monetary policy instruments including the central bank discount rate and reserve transport sector the government has developed an integrated programme that includes the rehabilitation and improvement of the main trunk roads, and improvement in the operations of the Tanzania Railways Corporation (TRC), the Tanzania-Zambia Railway Authority (TAZARA) and the Tanzania Harbours Authority. Comprehensive integrated programmes are in the process of being designed for the social sectors of education and health that will address the investment requirements of these sectors and how best to finance the recurrent cost of providing education health.

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Table 1 Average annual growth rates of GDP, GMP and sectoral GDP

	1965-85	1965-69	1970-74	1975-79	1980-85
Gross Domestic Product	3.3	5.5	3.6	3.4	1.1
Gross Material Product	2.3	5	2.5	2.5	-0.3
Agriculture	2.2	3.4	1.6	2.7	1.3
Manufacturing	3.5	11.8	5.6	3.8	-4.9
Public Administration	8.9	4.9	13.3	12.3	6.1
Share of Investment in total GDP	22.9	17.7	27.2	24.9	22.5

Table1A Production of major export crops ^1960/61-^1989/90(Thousand Tonnes)

Year	Cotton	Coffee	Sisal	Tea	Cashewnuts	Tobacco
1960/61	32 5	25.6	208 2	3 8	56 2	2.2
1964/65	53.2	31.8	233.6	4.8	74.1	2.1
1966/67	78 8	49 5	225	6 8	82 5	5 3
1968/69	51.5	51.5	196.9	7 9	117	11.7
1971/72	65 5	45 8	181 1	10 5	121 5	14 2
1972/73	77 1	51 6	156.8	12.7	122	13
1973/74	64 5	34 8	155 4	12 6	145 1	18 9
1974/75	70 5	50 3	142.1	12.9	117.2	14
1975/76	42 5	55 4	127 8	13 7	83	14 9
1976/77	67.1	48 7	119 1	16 7	96.8	19.1
1977/78	63 3	52 7	105	16 4	68	19.6
1978/79	56.2	40 2	91 9	17.6	57.1	17.1
1979/80	60 5	51 8	81 4	17 4	41.1	19.1
1980/81	58.6	67 5	86	16 9	64	16 8
1981/82	44.5	51.3	72.1	16	43.2	17 2
1982/83	42 9	53 8	60	17 5	32.5	13.9
1983/84	47	49 5	40.2	11.9	47	11
1984/85	51 9	49	38	16 8	32 4	13 4
1985/86	35.7	55	32.4	15.5	20.5	12.5
1986/87	56 3	54	30 2	14.1	16.5	16.2
1987/88	58.3	49.3	16	13.8	24 3	12 9
1988/89	63	49 5	15	15.6	19 3	11 7
1989/90	42.1	37.1	5.1	20.1	16.5	5.4

Source - Bank of Tanzania Economic and Operation Reports

Table 2 Balance of payments 1967-1991 (in million US$)

	1967	1970	1972	1974	1976	1977	1978	1979
Trade balance	4 2	-59 1	75 3	-338 9	-175 8	-203	-689 4	-558 1
Exports	233 5	259 2	382 2		466 8	571	497	545 5
Imports	229 3	381 5	403 5	79 1	642 6	774	1186 4	1103 6
Service (net)	-8 5	31 6	35 8	25 3	56	19 5	28 1	37 2
Transfers (net)	9 5	12 8	4 2	48 9	35 7	55 7	171 5	154 7
Current Account Balanc	5 2	-14 7	-35.3	-264.6	-64.1	-128.8	-489 8	-366 2
Capital Transactions (ne	21 1	66	121 5	124 5	-64 4	139 2	211 3	334 2
Exceptional financing				7.1		26 7	16 8	24.1
Overall balance	14 5	-3 2	66 2	-142 5	18 7	124 6	-262 6	50 7

1980	1981	1982	1983	1984	1985	1986	1987	1988
-712.8	-607 3	-697 4	-434.8	-485 7	-713 6	-699 9	-796.8	-812 2
505 8	553 7	415.4	379 7	388 3	285 6	347 6	353 2	380 2
1218 6	1161	1112.8	814 5	874	979 2	1047 5	1150	1192 4
19	69.9	38 8	23 2	-43 2	-68 1	-85.1	-99 1	-196 1
128 7	130 2	119 3	103 3	159 5	366 7	473	583	621 3
-565 1	-407 2	-539.3	-308.3	-369 4	-415	-312	-312 9	-387
226 8	258 7	193 4	208	35 7	-50 5	-76 4	-7	39 6
122.9	90.8	177.1	153 5	49.1	60	83	47.1	96
-178 1	-101 7	-109 3	-137 5	-158 7	-394 6	-383 6	-281 1	-257 9

1989	1990	1991
-834 8	-955 7	-987.7
395 2	407 8	393 6
1230	1363 5	1381 3
-219.2	-162.9	-155.4
652.2	693 5	407 7
-401 8	-425	-276.5
-32 3	137 2	124
143.7	20.3	32.5
-248.6	-276 8	-152 5

III
Asian and Latin American Experiences with Economic Policy Reform

POLICIES FOR

MACRO-ECONOMIC STABILITY

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Seimnar on

Effective Implementationof Policies for Growtn and Development in Africa:Bringing the Asian and latin America to Africa

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I. INTRODUCTION

Economists usually identify macro-economic stability with internal and external balances: the objectives of internal balance comprise full employment and price stability [absence of inflation] while external balance is defined to mean balance of payments equilibrium In a world where conditions are not static but dynamic, these goals need to be modified to include a reasonable rate of growth so as to ensure improvements in the standard of living. Moreover, in a world where exchange rates are neither permanently fixed nor freely floating, stability in exchange rates must also be included as a desirable objective

Macro-economic stability does not by itself ensure political or social stability; however, it makes it easier to achieve the latter. Inflation not only distorts resource allocation and distribution of income and wealth, it also creates social and political unrest Severe unemployment, often accompanied by inflation, has led to political turmoil in many countries. Balance of payments crises lead to large devaluations, eroding real wages and accentuate inequities in income and wealth distributions in some countries, riots have been known to occur after devaluations, in others Governments have been brought down

II. A VICIOUS CYCLE

Many African countries experience macro-economic instability: serious inflation, high unemployment, balance of payments deficits, with deteriorating standards of living Between the periods 1965-73 and 1980-87, the average inflation rate for Sub-Saharan Africa [SSA] excluding Nigeria more than tripled, from 5 9% to 20 4% [Table 2]. Dependence on external borrowing amounted to 4-5% of GNP [Table 1] Between 1970 and 1980, SSA's foreign debt-GNP rose from 13 to 81%, while the debt-service ratio almost tripled to 15% [Table 2] In terms of standards of living, independence brought most African countries an initial spurt of growth followed by stagnation and decline. Incomes per capita for SSA grew during the period 1961-72, followed by stagnation in the next period, 1973-80 Since 1981, most of the region have experienced economic decline. A World Bank Report has noted that, over-all, Africans are almost as poor today as they were 30 years ago The common experience has been weak agricultural growth, decline in industrial production, poor export performance, climbing debt, falling social indicators, deteriorating institutions and accelerating ecological degradation. In many cases, high and increasing population growth rates have contributed to the economic malaise: from 1980-87, population growth rates averaged 3 1% perannum compared to 2.6% in 1965-73 [1]

With few exceptions (e.g Botswana) Government Budget deficitshave been alarmingly large and growing [Table 1] Inevitably, in aworld where the industrial countries themselves face serious budget constraints, foreign aid and loans are harder to obtain. Moreover, the end of the Cold War has left many poor countries without rich suitors. The growing world shortage of savings in relation to burgeoning demands via economic reform programs of the countries of•the former Soviet Union, Eastern Europe, German reunification, Chinaand India can only to Africa's problems.

Typically, adjustment programs accompanying IMF and World Bankloans require cutting budget deficits by drastically reducing expenditures, lowering imports, and devaluations. The trauma of such adjustments can be seen in the light of the fact that many SSA countries are already suffering subsistence standards of living, with average per capita incomes of around U S.$340.

III. IDEOLOGICAL ROOTS

How did African and other countries get into the vicious cycle described above? I believe the roots are primarily ideological. Three ideologies may be identified, all contributing one way or another to the cycle

A. MACRO-ECONOMICS

Standard Keynesian economics has long taught that one of Government's key roles is to stabilise the economy· at times of recession, budget deficits are deemed necessary to stimulate effective demand. I do not propose to debate the subject. I merely want to point out certain consequences that are typically overlooked Firstly budget deficits can be financed via running down reserves, borrowing and/or printing money The first option threatens exchange rate stability, the second incurs debt, both domestic and foreign while the third produces inflation, which in turn causes exchange rate instability. Debts require repayment of interest and capital The more debt there is the greater the portion of the budget is frozen to service it The higher interest rates rise, the greater the budgetary burden Internally, therefore, there is great temptation to Governments to increase money and credit in order to ease their own debt service Externally, they are at the mercy of global financial markets. External debts are also usually denominated in hard currencies. This means that currency devaluations compound debt servicing problems. Moreover, inflation plus frequent devaluations lead to capital flight, further worsening the situation

Keynesian economics does not distinguish between Government expenditures which are consumption and which are investment Production capacity is assumed to be there and underutilised· all that is required is the additional effective demand

Typically, therefore, countries which have applied Keynesian prescriptions have large and growing national debts, large and growing, grossly inefficient public sectors. There is little or noattention to the productivity of the public sector Public spending per se does not produce prosperity; instead it has produced a host of problems. Increasingly, the need for fiscal discipline is being recognised. Brennan and Buchanan have argued that, for the mature democracies, constitutional limits should be placed on the Government's fiscal, debt and money-creation capacities. [2] The European Community has also set tough criteria for member countries to meet before they could move toward a single currency under the proposed economic and monetary union (EMU). The five criteria include price stability, currency stability, similar long term interest rates, budget deficits less than 3% of GDP and a public debt ratio not exceeding 60% of GDP. It was the violation of some of these rules that led to the exodus of Britain, Italy and Portugal from the ERM last year and threatens the future prospect of the EMU.

Persistent fiscal deficits lie at the root of the problem· they set in motion the vicious cycle noted earlier Higher taxes to finance part of the deficit create disincentives to work save and invest Borrowing crowd out private investments, worsen the national and external debts, besides freezing future funds for interest and armortization. Printing money to finance the deficit leads to inflation, currency devaluation, and more inflation Distortionary controls become inevitable· savings, investment, growth and living standards suffer

B. DEVELOPMENT ECONOMICS

Many developing economies have been the victims of the wrong types of development economics; three of these may be identified:

1) MARXIST/COMMUNIST

Although now discredited through the worldwide collapse of communism, the marxist/communist ideology greatly influenced many developing countries, particularly in Latin America, Africa and South Asia. The typical approach is central planning and allocation of resources by planners, bypassing the market The market mechanism is also hobbled by an extensive web of controls, particularly of prices In particular, domestic prices get severely distorted compared to world prices Witness the reform trauma that the so-called transition economies are undergoing and will experience for some time to come.

2) SOCIALIST

The socialist ideology emphasizes welfare programs and equity in income and wealth distributions When countries are poor to start with, the effect is to share poverty· worse still, poverty becomes entrenched. Wealth must first be created before any sharing can take place Moreover, typically, welfare programs undermine incentives to work. Overly progressive wealth and income taxes undermine entrepreunership and enterprise. Instead, whatever creative energies are available are channelled into rent-seeking activities. In countries where governmental controls are legion, such activities are rewarding but distorting, to the detriment of the econnomy. Corruption usually becomes rife. Economic stagnation becomes compounded by a severe brain drain as the better educated migrate in frustration.

3) MARKET FAILURE

A third strand in the development ideology adopted by many developing countries is the belief that markets are inefficient if not structurally defective for resource allocation. Massive government intervention is then advocated to accelerate the development process. This typically involved government ownership and control of many economic activities ranging from dams to finance Nationalisation became common and State-Owned Enterprises (SOE's) dominate the economic landscape. The tragedy is that most of these are loss-making because of political patronage, corruption and inefficiency. An IMF study of 64 SOE's in developing countries revealed and average rate of return before tax of -4.8% [3] The record for Asian countries is not much better:

"Several factors have contributed to this low productivity of public investment These include (i) the choice of unprofitable investment projects for political or other reasons, (ii) less emphasis on efficiency than on objectives such as employment, redistribution of income and regional development, (iii) low capacity utilisation, (iv) poor pricing policies, (v) managerial staffing at times based more on political considerations than on managerial ability, (vi) the absence of discipline imposed by competition and profit motive, and (vii) for some of them in recent years, the fall in commodity prices "[4]

What compounds the tragedy is that many governments continue to subsidise such loss-making operations and worsen their already huge budget deficits

C. IMPORT SUBSTITUTION INDUSTRIALISATION [ISI]

The financial and development distress described above can also be traced to another related ideological root the import substitution method of industrialisation adopted by many developing countries since the early fifties Many studies by the World Bank and others in academmia have conclusively documented the monumental failure of the ISI strategy. What concerns me here is the compounding effect upon macro-economic instability

The ISI route to industrialisation typically required the erection of tariffs and quotas often accompanied by multiple exchange rates The initial stage involved the protection of final consumer goods followed by later stages of protection of intermediate and capital goods Instead of improving the balance of payments, ISI worsened it because it discouraged and penalised exports and paradoxically encouraged imports, especially of components for assembly and production inputs Meanwhile ballooning budget deficits and inflation led to devaluations and rationing of foreign exchange: the scarcity of vital imported inputs caused considerable capital losses and affected the viability of banks' portfolios

Because of its inward-looking nature, protectionism made growth of industrial production dependent on domestic demand: the high-cost goods cannot compete in the world market. This then led to governments engaging in deficit-spending to maintain high rates of growth of domestic demand, with adverse consequences for balance of payments. As noted earlier, after drawing down reserves, the budget deficit can only be financed through monetization (inflation) and borrowing. The borrowing is largely external because of the shortage of domestic savings (to be explained below). Such a process is not only finite, but also short-lived and expensive Moreover, domestic markets are small and unable to provide economies of scale The result is high-cost production and industrial stagnation

ISI also distorts the internal price structure, penalizing agricultural production. This effect is compounded by the political necessity of maintaining relatively high real industrial wages, partly achieved by keeping food prices low. Many countries therefore cannot produce enough food for themselves; the required imports only made the balance of payments worse.

ISI, by distorting relative prices internally and in relation to the rest of the world, made it more difficult for those countries to adjust to international commodity price cycles, interest rate changes and exchange rate alignments They were largely bypassed as the rest of the world internationalised and globalised They could not respond adequately to rapid developments of technology and shifts in consumption patterns

IV. FINANCIAL REPRESSION

W. Arthur Lewis (1954) had long ago identified the central task of economic development to be that of raising the savings (S) and investment (I) rates from 4-5% to 12-15% of GNP Table 1 shows that the average savings rate for SSA actually declined from 14% in 1965 to 13% in 1987 If Nigeria is excluded, the decline is even more severe. from 15% to 11 For the 31 low-income SSA countries, excluding Nigeria, the decline in S is even more dramatic from 14% in 1965 to only 7% in 1987 Seven of the SSA countries even had negative S rates! Three South Asian countries, viz , Bangladesh, Pakistan and Sri Lanka, also suffered declines in their savings rates (Table 6). On the other hand, most of the ASEAN countries increased their saving rates sub-stantially. Among the newly-industrializing countries (NIES), Singapore and S.Korea had spectacular increases in their savings rates between 1965 and 1989 In 1965, both NIES had •less than• 10% savings rates. S.Korea increased her S to 37% while Singapore achieved an astounding 47% last year! The experiences of S Korea and Singapore, both with little or no natural resources, indicate what is possible for SSA countries to achieve It should be noted that even a populous country like India could increase her S to 21% (Table 6).

Quite clearly, despite foreign financing, the savings rates of SSA and other low-income developing countries imply that they could barely maintain their existing capital stock and could not generate enough investment to employ the increasing labor force, let alone increase per capita incomes. The average investment (I) rate for SSA was only about 16% in 1987 (Table 1), marginally above the 14% recorded for 1965. For South Asia, except for Myanmar and Bangladesh, the I rates were higher than SSA Most of the Asean countries and the NIES had over 30% I rates (Table 6)

The World Bank [5] has estimated that, to increase real GDP growth of SSA to 4-5% per annum would require an I rate of 25% and a S rate of 18% by the year 2000 and 22% by 2020 Even such herculean efforts would still mean a dependence on foreign financing of 9% of GDP by the year 2000 and 5% by 2020. In the meantime, ODA needs to increase in real terms by 4% per year

The low S and I rates of SSA countries reflect the classic symtoms of financial repression described by McKinnon [6] in 1973 The first has to do with the effects of high inflation and low nominal deposit rates (Table 3) which limit financial intermediation by the banking system The Asian experience (Table 7) has been generally declining rates of inflation and more attractive bank deposit rates (Table 8). As a result, financial development has been very significant in Asia but has been very retarded in Africa Table 1 shows that only 7 out of 32 countries of SSA had a financial deepening ratio (M2/GDP) in excess of 27% All the Asian countries listed in Table 6 had such ratios in excess of 27% Together with financial liberalization, the Asian countries have therefore been able to mobilize more savings and enjoy greater rates of investment, more efficiently as well

Limited financial intermediation also directly restricts real output by starving firms of needed working capital The third aspect of financial repression manifests itself through the maintenance of an overvalued currency, which, together with foreign exchange shortage, works to severely limit the imports of much needed intermediate goods

V. THE EFFICIENCY OF INVESTMENT

It was not merely the higher levels of I that accounted for the better growth rates of Asian countries, including South Asia More fundamentally, it was the incremental output-capital coefficient (ICOR) that contributed substantially to the difference in• growth performance According to a World Bank [7] report on SSA, the ICOR dropped dramatically from 31% of I in the 1960's to only 2 5% in the 1980's It was *not* primarily external factors that caused the economic decline in SSA but rather the low return on I. The same World Bank Report also showed that SSA's I and operating costs are typically 50-100% above those of S Asia [8] Several factors responsible for this were noted:

(a) Weak public sector management, resulting in
  * loss-making public enterprises
  * poor I choices

* costly and unrealistic infrastructure
* price distortions, especially overvalued exchange rates administered prices and subsidized credits,

(b) Inefficient resource allocation
(c) High wage costs
(d) Inappropriate technologies, especially the neglect of intermediate technologies.
(e) Deteriorating quality of governance:

* bureaucratic obstruction
* pervasive rent-seeking
* weak judicial systems
* arbitrary decision making.

VI. GOVERNMENT FAILURE

Ironically the various failed policies which produced so much macro-economic instability were instituted in various countries to overcome the problem of market failure. In the early fifties, the prognosis of some influential economists like Raul Prebisch and Hans Singer was pessimistic for export-oriented growth Now, the development literature is full of documented cases of government failure In addition to the problems of ISIreferred to earlier, State allocation and control created rents which were exploited by various groups, usually in coalition with the governing party To this should be added the predatory behaviour of bureaucrats and politians themselves A third source of government failure is the lack of well-trained, competent, properly paid bureaucrats in key policy-making agencies It has been estimated that ISI-related rent-seeking activities consume as much as 15% of the GNP [9]

The new political economy seeks to explain government failure and success in the context of economic development Some view the fundamental development challenge to be how to create institutions that can minimise government failure Others focus on the ideal developmental state, which may be characterised as follows [10]

1.Honest and effective politicians;
2.Having a highly trained, properly-paid, efficient bureaucy,
3.Optimal government intervention to deal with market failure using non-distortionary taxes and subsidies,
4.Relatively free trade regime,
5.Provision of public, merit and strategic goods,
6.Maintaining a stable macro-economic climate;
7.Relative autonomy or insulation from the distorting contentions of distributional coalitions (i e rent-seeking groups).

VII. THE EXPERIENCE OF SINGAPORE

A. MACRO-ECONOMIC STABILITY

With a population of 2.8 million living on 635 sq. km., Singapore is one of the smallest nations in the world. It has no natural resources, has to import most of its food, and is completely dependent on imported energy Its modern history dates back to 1819, when SirStamford Raffles established it as a free trading port. In 1960, a year after the British granted self-rule, per capita GNP was merely U S.$443; at the end of last year, 32 years later, the figure had multiplied nearly 32 times to U.S.$14,091. Gross National Savings(GNS) was negative in 1960 (-U.S.$17 million) but rose to U.S.$21.7 billion or 46.4% of GNP by 1992. The Official Reserves (foreign assets) tell a similar story: they rose from U.S $384 million in 1963 to U.S.$40.4 billion in 1992. External debt was minuscule in 1992 U S $16 5 million The rate of inflation was 2.3% (CPI) or 2.0% (GDP deflator). Real GDP grew at an average 8.4% between 1960 and 1992.

There are many factors acounting for Singapore's remarkable performance but one of the key elements is macro-economic stability Available data from 1966 shows that the Public Sector as a whole (inclusive of major Statutory Boards) has produced yearly surpluses (current revenue less current expenditure). In 1985, the share of the Public Sector in GNS reached an astounding 69.3%. Financial prudence underlies budgetary policy: subsidies are provided only for education, health and housing. Even in terms of housing subsidy, much of it is in terms of imputed market value, i e. requiring no actual outlays when land belongs to the State.

There are no unemployment benefits and welfare expenditure for the poor, aged and destitute is minimal. The philosophy of Government is that every able-bodied person must work to support himself and his close relatives. Public development projects are carefully designed, costed and monitored to ensure efficiency and viability: users are charged at prices that recover cost and replacement Bond issues to raise money for public projects are virtually unheard of. Monetary economists complain of an inactive secondary government bond market: the only bonds issued are to satisfy statutory requirements of banks and the Central Provident Fund. The latter is a compulsory savings scheme that currently requires 18% and 22% contribution (based on wages) respectively from employers and employees Workers can use the Fund to buy houses, pay medical bills and for retirement. The Fund is operated independently of the Government budget and pays interest. In 1988, contributions to the Fund amounted to nearly 24%of GNS

Balance of Payments figures show that from 1986, Singapore became a net international creditor for the first time. Last year, the current account surplus amounted to 6.3% of GNP, reflecting the excess of savings over domestic investment.

The Public Sector surpluses plus the high national savings rate set in motion a *virtuous cycle*, in contrast to the vicious cycle noted earlier: the net withdrawal of liquidity causes a capital inflow which strengthens the Singapore \$. The Central Bank (Monetary Authority of Singapore: MAS) intervenes in the foreign exchange market to buy up U.S.\$. Domestic liquidity is restored and foreign reserves are accumulated. Inflation is negligible and there is confidence in the Singapore \$, which helps in attracting long-term foreign investment.This confidence is reinforced by another institutional arrangement Like many African countries which were former British colonies, Singapore inherited a Currency Board which is empowered to issue currency backed by at least 100% foreign exchange. This system has been retained to great advantage, because the Government cannot print money at will.

The system just described means that monetary policy is merely ensuring sufficient liquidity and is essentially dictated by exchange rate policy. Since 1973, Singapore has used a managed float system to regulate exchange rates However, because of the twin surpluses of Savings-Investment and the Public Sector Budget, exchange rate management is simple and merely means deciding on the rate of growth of foreign exchange reserve accumulation, consistent with price stability and export competitiveness.

B. INDUSTRIALISATION POLICY

When the present People's Action Party took power in 1959, it identified industrialisation as the answer to Singapore's development problems. Up till that point in time entrepot trade had been the mainstay of the economy Accomodation to the vicissitudes of trade took the form of emmigration of the Chinese and Indians back to their respective ancestral lands. After the communist take-over of China, however, the Singaporean Chinese had no more option Rapid population growth meanwhile plus urban migration from nearby Malaya produced an unemployment rate of 13.5%. The Government saw the solution in an import-substitution industrialisation (ISI) in the context of a proposed common market with Malaysia Fortunately, partly because of the political turmoil involved in getting into and out of the Malaysian federation, the ISI was not carried very far There were few quotas and generally, nominal tariffs were low, below 25%. Less than one quarter of all manufacturing industries were protected. For the manufacturing sector as a whole, nominal protection amounted to 3-5% while effective rates ranged between 6-9%, very [11] low, compared to the experience of other developing countries.

The year 1967 can be described as a watershed: the British announced their intention to withdraw their troops and close their bases by 1971 17.6% of the GDP and 20% of employment were at stake. The Government's response was to turn towards a foreign-investment and export-oriented industrialisation The Economic Expansion Incentives (Relief from Income Tax) Act of 1967 had the following features:

(i) the tax on approved export earnings was reduced from 40% to 4% for a period of up to 15 years;

(ii) the tax on royalties, fees etc payable to enterprises abroad was reduced to 20% or completely exempted;

(iii) complete tax exemption was granted on interest received by foreigners on approved loans to Singapore firms; and

(iv) tax withholding on nonresident interest earned from bank deposits was reduced to 10%.

These incentives have been added to and enhanced in various ways over the years. The export-oriented development has become an example for others.

C. THE BUSINESS CLIMATE

Unsurprisingly, transnational corporations find Singapore's business climate one of the best in the world The Economic Committee Report(1986) has encapsuled the Government's commitment to foster a conducive business environment The ingredients listed are competitive wages, rentals and utility charges, low taxes, friendly regulations, and good work attitudes The recent Budget announced a corporate tax cut from 30 to 27% and an income tax cut at the margin from 31 to 28% effective next year.

Lee and Naya have characterised the nature of Government-business relations in the NIEs as akin to a quasi-internal organisation This is certainly true of Singapore. Singapore Inc. finds expression in the concept of tripartism, whether in wage-guidance, industrial relations, productivity improvements or in frequent consultations about business- related legislation

D. FOREIGN INVESTMENT

Singapore was one of the first developing countries to realise the advantages of having foreign investments Foreign investors dominate the manufacturing scene: wholly-owned and majority-owned foreign firms account for 70% of gross output, 65% of value-added, 53% of employment and 82% of direct exports Foreign firms typically produce to export if only because of the smallness of the domestic economy. Their presence has not led to political interference nor caused economic displacement. Instead, the economic growth and employment generated has enhanced political and economic stability More importantly, their presence has produced important positive demonstration effects Local firms have upgraded their technology, recruitment procedures and introduced training programs. Moreover, supporting industries have sprung up; service industries, transportation, communications, finance and tourism have at least been partly stimulated by the activities of the transnationals

E. GOVERNMENT AS ENTREPRENEUR

Although Singapore has pursued a free trade, export-oriented policy, the Government's role in the economy is interventionist in that it has gone beyond the provisions of law and order, public goods like education, health and basic infrastructure The Public Sector's share of Gross Domestic Fixed Capital Formation has averaged 25%, somewhat more than Korea's (17 6% in 1984) but less than Taiwan (42 7% in 1984) In addition, it has substantial interest in over 500 Government-Linked Companies (GLCs) Some idea of the size of the Government's direct business involvement may be gleaned from the figures released by the Public Sector Divestment Committee. It disclosed that, the total value of shares from 23 of the 505 GLCs and 4 out of 7 Statutory Boards earmarked for privatisation would amount to U S.$12.8 billion, compared to an estimated supply of private investible surpluses of U.S $18.8 billion.

The GLCs are involved in manufacturing, petrochemicals, trading financial services, shiprepair and shipbuilding, shipping, aviation, engineering, light military weapons, health services, tourism, leisure, real estate, construction and housing (other than public housing) and farming

In addition to the GLCs, there are seven major Statutory Boards with substantial commercial operations their assets are worth over U.S.$11 billion and they generate over U.S.$511 million in annual surpluses

The success of the manufacturing, commercial and financial operations of GLCs and Statutory Boards may be due to special factors. In the first place, only competent people are appointed to run these operations. Secondly, strictly commercial principles are observed there is no bailout of bankrupt companies. Thirdly, the Companies' Act is strictly enforced.

F. INDUSTRIAL RELATIONS

Another key factor that has helped Singapore maintain macro-economic stability is the system of industrial relations. Powerful and confrontationist trade unions have caused real wages to be too high, and have contributed to wage-price spirals, resulting in structural unemployment in many countries, both developed and developing In the fifties and early sixties, left-wing dominated trade unions in Singapore caused much industrial unrest and scared away much needed investment, both local and foreign.

Two major pieces of legislation were introduced in 1968 which had profound and beneficial effects on the system of industrial relations in Singapore the Employment Act and the Industrial Relations (Amendment) Act reduced labor costs and gave greater discretion to employers in the development of their labor force Restrictions were placed on bonuses, leave, retrenchment benefits, retirement benefits, overtime claims, the hours of work were increased. Employers were given unbargainable rights in promotions, internal transfer, hiring and firing

Trade unions were reorganised. Union leaders were given prominent roles in Parliament and Cabinet and represented on important Statutory Boards. Their energies were channelled into education and retraining of workers and into cooperatives whose business ventures are widespread, extending into insurance, retail, medical care, taxis and leisure resorts. These ventures are operated on strictly commercial principles but the profits are used to give rebates and concessions to members.

The results were salutary Industrial strife was virtually eliminated. For many years now, Singapore has enjoyed a reputation of having one of the best industrial climates in the world with good work attitudes and productivity consciousness. This has surely kept inflation low.

G. MERITICRACY

One of the major problems of developing countries is the lack of competent and honest civil servants. Singapore has carefully followed a system of meritocracy. Some of the best brainsare inducted into public service by an impartial Public Services Commission. Pay scales are regularly revised to ensure competitiveness with the private sector. Promotions for the brightest and ablest are accelerated In fact, the Government borrowed personnel recruitment and promotion procedures from the transnaional corporations.

High standards of honesty and integrity are rigorously enforced The Corrupt Practices Investigation Bureau operates directly under the Prime Minister. The ruling party's members of Parliament and ministers are carefully chosen Some who fell afoul of the standards found themselves in jail or out of office, their reputations tarnished. It has been observed that a technocratic elite has often been instrumental in proposing and implementing economic reforms in developing countries. This is certainly true in Singapore and other Asian NIEs and Southeast Asian countries. It may also be mentioned that most of these technocratic elites were trained in the U.S or Europe, often through aid programs

VIII. DEMONSTRATION EFFECTS

The success of the Asian NIEs in terms of macro-economic stability and progress has had a beneficial impact on other countries, particularly in Southeast Asia. Although governments were less strong their technocrats have been able to override opposition to reform.[13] These technocrats are usually western-trained. Moreover, there were spill-over effects in terms of investment, trade and official contacts It has been argued that the business sector has also been instrumental in pushing for economic liberalisation in Southeast Asia.

IX. •HINDRANCES TO STABILISATION•

It has been argued that macro-economic stabilisation programs are hindered by a number of factors in some countries The Asian experience may have some relevance.

External shocks like oil price hikes and commodity price cycles are part of the Asian scene. Singapore adjusted to the two OPEC price shocks by not sheltering producers and consumers and by increasing productivity and energy conservation. Most of the other NIEs and Southeast Asian countries did likewise

Indonesia and Malaysia also suffer from commodity price cycles: they overcame them by fiscal and monetary restraint and by devaluations

Even political constraints did not seriously hinder adjustment programs Malaysia's ethnic concerns may have reduced growth for a while over the last five years, more stable macro-economic policies plus export-oriented development have resulted in growth rates of over 8% per annum In Korea, the bailouts of the huge conglomerates (chaebols) have not seriously hindered growth either

The generally more stable macro-economic environment has even permitted the absorption of the consequences of costly mistakes For example, S Korea in the seventies unwisely invested huge amounts in heavy and chemical industries Taiwan went into steel, shipbuilding petrochemicals and car manufacture at great cost Singapore's huge investment in petrochemicals nearly became a white elephant and the 1979 wage restructuring policy pushed up business costs severely

FOOTNOTES

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Table 1: Sub-Saharan Africa Macro Indicators I

	Budget Deficit		Gross Domestic Savings		Gross Domestic Investment		Resource Balance		M2/GDP	
	1972	1987	1965	1987	1965	1987	1965	1987	1965	1987
Sub-Saharan Africa										
Total			14	13	14	16	1			
Excluding Nigeria			15	11	15	16	[illegible]	-4		
Low-Income Economies			13	10	14	16	1	-6		
Excluding Nigeria			14	7	14	16	0	-9		
1 Ethiopia	-1 4	-6 8*	12	3	13	14	-1	-11	12 5	41 4
2 Chad	-2 7	-1 3	6	-12	12	18	-6	-31	9 3	25 3
3 Zaire	-3 8	-6 8*	30	10	14	13	15	-3	11 1	8 8
4 Guinea-Bissau		-26 2		5		19		-14		16 3
5 Malawi	-6 2	-10 3	0 0	12	14	14	-14	-2	17 6	25 0
6 Mozambique				-10		22		-32		
7 Tanzania	-5 0	-4 9	16	-6	15	17	1	-23		25 9
8 Burkina Faso	0 3	1 6	4	1	12	24	-8	-23	9 3	23 1
9 Madagascar	-2 5		4	7	10	14	-6	-7	19 6	25 7
10 Mali		-10 0	5	0	18	16	-13	-17		22 5
11 Gambia, The	0 2		3	6	8	19	-5	-13	16 9	24 3
12 Burundi	0 0		4	8	6	20	-2	-12	10 1	15 6
13 Zambia	-13 8	-15 8	40	20	25	15	15	5		30 6
14 Niger			3	5	8	9	-5	-5	3 8	18 1
15 Uganda	-0 1	0 0	12	5	11	12	1	-7		7 8
16 Sao Tome and Principe				-6		44		-50		113 9
17 Somalia	0 6		8	1	11	35	-3	-34	12 7	16 1
18 Togo		-5 0	17	6	22	17	-6	-12	10 9	44 5
19 Rwanda	-2 7		5	5	10	17	-5	-12	15 8	16 7
20 Sierra Leone	-4 4	-8 9	9	10	12	9	-3	1	11 7	10 3
21 Benin			3	4	11	14	-8	-10	10 6	20 4
22 Central African Rep			11	-2	21	14	-11	-16	13 5	18 3
23 Kenya	-3 9	-4 6	15	20	14	25	1	-5		39 9
24 Sudan	-0 8		9	6	10	11	-1	5	14 1	35 5
25 Comoros				-11		12		-23		16 3
26 Lesotho	3 5	-2 6	-26	-73	11	25	-38	-99		49 3
27 Nigeria	-0 7	-10 3	12	20	14	16	-2	4	9 9	26 3
28 Ghana	-4 2	0 6	8	4	18	11	-10	-6	20 3	11 7
29 Mauritania		-4 2*	27	14	14	20	-13	-7	5 7	23 5
30 Liberia	1 1	-7 9	27	18	17	10	-10	9		19 1
31 Equatorial Guinea			28		19		9			
32 Guinea				17		17		0		5 5
Middle-income Economies			17	16	15	16	1	0		
33 Cape Verde										
34 Senegal	[illegible]		8	6	12	13	-4	-7	15 3	23 5
35 Zimbabwe		-10 8	23	22	15	18	8	3		61 6
36 Swaziland	-4 2	1 8	38		26		12			
37 Cote d'Ivoire			29	19	22	13	7	6	21 8	31 0
38 Congo, People's Rep			5	21	22	24	-17	2	16 5	20 8
39 Cameroon		-3 5	12	15	13	18	-1	4	11 7	18 7
40 Botswana	-23 8	28 2	-13	27*	6	24*	-19	13*		29 5
41 Mauritius	-1 2	0 2	13	29	17	26	-4	3	27 3	50 0
42 Gabon	-12 9	0 1	37	34	31	31	6	3	16 2	24 4
43 Seychelles	3 4									29 5
44 Angola			12	16	10	9	2	6		
45 Djibouti										

Sources

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Note * 1989 Data
Not Available

Table 2 Sub-Saharan Africa: Macro Indicators II

	Inflation Rate		Foreign Debt / GNP		GNP per Capita US$	ODA / GNP	Debt Service / Exports	
	1965-73	1980-87	1970	1987	1989	1989	1970	1987
Sub-Saharan Africa								
Total	7 5	15 2	13	81	340		5 3	14 7
Excluding Nigeria	5 9	20 4	18	74			5 5	16 1
Low-Income Economies	8 2	17 0	12	92			5 5	14 8
Excluding Nigeria	6 7	27 5	18	86			5 8	17 9
1 Ethiopia	2 0	2 6	10	46	120	11 6	11 4	28 4
2 Chad	4 6	5 3	10	28	190	23 5	4 2	3 9
3 Zaire	19 0	53 5	9	140	260	6 6	4 4	12 8
4 Guinea-Bissau		39 2		321	180			37 0
5 Malawi	3 7	12 4	43	98	180	24 9	7 8	23 3
6 Mozambique		26 9			80	59 2		
7 Tanzania	3 4	24 9	20	144	120	32 0	5 3	18 5
8 Burkina Faso	1 9	4 4	7	44	320	11 1	6 8	
9 Madagascar	4 6	17 4	10	163	230	12 6	3 7	35 3
10 Mali		4 2	71	96	270	22 6	1 4	9 9
11 Gambia, The	3 0	13 8	10	151	240		0 5	12 9
12 Burundi	3 0	7 5	3	60	220	18 6	2 3	38 5
13 Zambia	5 8	28 7	36	228	390	8 3	6 4	13 5
14 Niger	4 1	4 1	5	60	290	14 5	4 0	33 5
15 Uganda	5 6	95 2	7	30	250	8 4	2 9	19 5
16 Sao Tome and Principe		4 9		337	312			41 5
17 Somalia	4 5	37 8	24	237	170	38 9	2 1	8 3
18 Togo	2 9	6 6	16	91	390	13 6	3 1	14 2
19 Rwanda	7 2	4 5	1	26	320	11 0	1 2	11 3
20 Sierra Leone	2 1	50 0	14	55	220	10 5	10 8	
21 Benin	2 9	8 2	15	57	380	14 7	2 4	15 9
22 Central African Rep	3 0	7 9	14	49	390	17 1	5 1	12 1
23 Kenya	2 4	10 3	21	58	370	11 7	6 0	28 8
24 Sudan	7 2	31 7	15	97	641		10 7	6 8
25 Comoros			5	95	450			5 2
26 Lesotho	4 1	12 3	8	37	470	26 0	4 5	4 4
27 Nigeria	9 1	10 1	3	110	250	1 1	4 3	10 0
28 Ghana	8 1	48 3	23	45	390	10 3	5 5	19 2
29 Mauritania	4 1	9 8	14	215	490	19 4	3 4	18 2
30 Liberia	1 6	1 5	39	108			8 1	2 5
31 Equatorial Guinea			8		430		0 0	23 1
32 Guinea	2 9	55 1	47	78	430	12 6		
Middle-Income Economies	4 7	6 8	18	57			4 6	14 6
33 Cape Verde		13 9		69	760			
34 Senegal	3 0	9 1	12	68	650	14 0	2 9	21 4
35 Zimbabwe	2 3	12 4	16	36	650	4 5	2 3	23 2
36 Swaziland	4 3	10 2	33	46	900			6 1
37 Cote d'Ivoire	2 7	4 4	19	90	790	4 4	7 1	19 6
38 Congo, People's Rep	4 4	1 8	47	195	940	4 0	11 5	18 6
39 Cameroon	7 5	8 1	12	23	1000	4 2	3 2	15 9
40 Botswana	4 4	8 4	21	38	1600	6 5	1 0	3 7
41 Mauritius	5 5	8 1	14	31	1990	2 7	3 2	6 1
42 Gabon	5 8	2 6	29	53	2960	3 9	5 7	5 1
43 Seychelles	7 3	3 7		35	4170			
44 Angola	3 9				620	1 8		
45 Djibouti								

Sources

1 Same as Table 1 Tables 1, 22,
2 The World Bank, World Development Report, 1991, Table 20
3 Country Profiles, United Nations

Note Not available

Table 3 Africa Nominal Interest Rate of Banks, 1987
(Average Annual Percentage)

	Deposit Rate	Lending Rate
Low-Income Economies		
1 Ethiopia	1 0	6 0
2 Chad	5 3	10 5
3 Zaire		
4 Guinea-Bissau		
5 Malawi	14 3	19 5
6 Mozambique		
7 Tanzania	15 8	27 5
8 Burkina Faso	5 3	8 0
9 Madagascar	11 5	14 5
10 Mali	5 3	8 0
11 Gambia, The	15 8	27 9
12 Burundi	5 3	12 0
13 Zambia	13 2	21 2
14 Niger	5 3	8 0
15 Uganda	30 0	34 7
16 Sao Tome and Principe		
17 Somalia	15 3	22 0
18 Togo	5 3	8 0
19 Rwanda	6 3	13 0
20 Sierra Leone	12 7	28 5
21 Benin	5 3	8 0
22 Central African Rep	7 2	11 4
23 Kenya	10 3	14 0
24 Sudan		
25 Comoros	6 5	13 0
26 Lesotho	7 0	11 1
27 Nigeria	13 1	14 0
28 Ghana	17 6	25 5
29 Mauritania	6 0	12 0
30 Liberia	5 9	13 6
31 Equatorial Guinea	6 0	13 5
32 Guinea		
Middle-Income Economies		
33 Cape Verde		
34 Senegal	5 3	8 0
35 Zimbabwe	9 6	13 0
36 Swaziland		
37 Cote d'Ivoire	5 3	8 0
38 Congo, People's Rep	7 8	11 1
39 Cameroon	7 2	13 0
40 Botswana	7 5	10 0
41 Mauritius	9 4	14 1
42 Gabon	7 9	11 1
43 Seychelles	10 0	13 0
44 Angola		
45 Djibouti		

Source The World Bank, *Sub-Saharan Africa*, op Cit, Table 27

Note Not available

Table 4 Africa: Central Government Expenditure, 1987

	Defense %	Education %	Health %	Housing Welfare etc %	Economic Services %	Other %	Total GNP
Low-income Economies							
1 Ethiopia*		10 6	3.6	9.3	30 1	46 5	35.2
2 Chad	..	..	...	..	...	..	9 0
3 Zaire	14 0	6.1	4 3	4.6	25 9	45 1	18.4
4 Guinea-Bissau	4 4	5.2	5.4	17.1	40 0	27 9	71 5
5 Malawi	6.6	10.8	7.1	2.3	33.7	39.6	35.1
6 Mozambique		..	.	.		.	...
7 Tanzania	15 8	8 3	5.7	1.7	27.5	41 2	20.9
8 Burkina Faso	17.3	19 0	5 8	3 4	7 7	46 8	16 3
9 Madagascar	...	..	..	...	.	..	...
10 Mali	8.0	9.0	2.1	3 1	5.3	72.4	28 9
11 Gambia, The	..	...	...	..	...	...	...
12 Burundi	.	...	..	..	..	.	.
13 Zambia	0 0	8 3	4.7	2 3	21.0	63.7	40.3
14 Niger	...	...	..	...	..	..	..
15 Uganda	26 3	15 0	2 4	2 9	14 8	38 6	0 1
16 Sao Tome and Principe	...		.	...	.	..	..
17 Somalia	...	..	...	..	...	...	...
18 Togo	7 6	13 1	3 8	9.9	31 8	33 8	41.5
19 Rwanda	..	..	..	..		.	..
20 Sierra Leone	..			..		.	13 7
21 Benin	.	.					.
22 Central African Rep	...		..	..		.	..
23 Kenya	9 1	23 1	6 6	1.7	22 8	36 8	25 0
24 Sudan	..		..	...	..	..	...
25 Comoros	.	..	..	..	.		..
26 Lesotho	9 6	15 5	6 9	1.5	25 5	41 1	21.3
27 Nigeria	2.8	2 8	0 8	1 5	35 9	56 2	27.7
28 Ghana	6 5	23.9	8 3	7 3	15 7	38 3	14.1
29 Mauritania	.	.		.			
30 Liberia	8 9	16 2	7.1	1.9	27.6	38.2	24 8
31 Equatorial Guinea	.	.	...	...		.	.
32 Guinea	.				..	...	...
Middle-income Economies							
33 Cape Verde	..	.	.	..	.		..
34 Senegal	.	...	.	...	.	.	
35 Zimbabwe	14 2	20.3	6 1	4.6	41 4	13 3	40 3
36 Swaziland	5 3	24.8	9 4	2 3	25 1	33.0	24.9
37 Cote d'Ivoire	..		.	..	.	..	..
38 Congo, People's Rep	..	.		.	..	...	.
39 Cameroon	8 1	12.7	3 5	11 9	35.7	28 0	23 4
40 Botswana	7.9	18 4	5.9	10.1	28 4	29 2	47 5
41 Mauritius	0 8	12.4	7 6	17 4	21 6	40.3	23 0
42 Gabon	.	..	.	..	.		45 9
43 Seychelles	.	.	..	.		.	..
44 Angola	..	..	...	..	..		..
45 Djibouti	..	.	.	...	..	...	...

Sources.

The World Bank, Sub-Sahara Africa op cit , Table 25

Note. * 1989 figure from World Bank, World Development Report, 1991, Table 11

. Not available

Table 5· Africa Central Government Current Revenue 1987

	Percentage of Total Current Revenue						Total GNP
	Taxes on Income Profit and Capital Gains	Social Security	Domestic Taxes on Goods and Services	Taxes on International Trade	Other Taxes	Non Tax Revenue	
Low-income Economies	26 6	0 0	21 0	19 6	2 2	30 7	25 2
1 Ethiopia*	20 8	0 0	8 6	46 2	12 7	11 6	5 7
2 Chad	29 9	0 9	15 1	33 4	5 6	15 2	16 3
3 Zaire	7 2	1 2	30 3	39 8	-14 1	35 6	17 8
4 Guinea-Bissau	35 5	0 0	28 9	16 8	0 6	18 2	22 6
5 Malawi							
6 Mozambique	25 8	0 0	57 4	8 6	3 1	5 1	16 3
7 Tanzania	20 6	7 6	22 7	39 4	6 8	10 5	15 3
8 Burkina Faso							
9 Madagascar	8 2	4 6	22 2	28 1	26 9	10 1	15 1
10 Mali							17 7
	16 1	0 0	9 9	66 4	1 1	6 5	
11 Gambia, The							
12 Burundi	23 5	0 0	40 2	32 9	0 5	3 0	24 4
13 Zambia							
14 Niger	5 5	0 0	19 1	75 3	0 0	0 0	0 0
15 Uganda							
16 Sao Tome and Principe	30 5	6 3	7 7	32 3	1 1	22 2	31 8
17 Somalia							
18 Togo	28 0	0 0	25 0	40 4	1 0	5 6	6 5
19 Rwanda							
20 Sierra Leone							
21 Benin	30 4	0 0	38 0	19 2	1 5	10 9	20 8
22 Central African Rep							
23 Kenya							
24 Sudan	11 1	0 0	10 3	67 8	0 2	10 5	22 0
25 Comoros	39 9	0 0	5 1	6 6	-14 5	62 9	18 5
26 Lesotho	21 5	0 0	25 3	42 5	0 1	10 6	14 5
27 Nigeria							
28 Ghana	34 1	0 0	32 0	26 9	2 5	4 4	17 0
29 Mauritania							
30 Liberia							
31 Equatorial Guinea							
32 Guinea							
Middle-income Economies	42 8	0 0	30 6	15 6	1 1	10 0	28 9
33 Cape Verde	38 2	0 0	11 4	42 2	1 0	7 3	27 3
34 Senegal							
35 Zimbabwe							
36 Swaziland	31 3	5 4	14 9	18 7	4 0	25 8	18 8
37 Cote d'Ivoire	38 1	0 0	1 2	13 4	0 1	47 2	75 2
38 Congo, People's Rep							
39 Cameroon	10 0	4 3	18 3	50 5	4 2	12 8	23 3
40 Botswana	44 2	0 0	6 5	16 2	1 9	31 2	47 1
41 Mauritius							
42 Gabon							
43 Seychelles							
44 Angola							
45 Djibouti							

Sources

The World Bank, Sub-Saharan Africa, op. cit., Table 26

Notes

* 1989 figure from World Bank, World Development Report, 1991, Table 12
Not available

Table 6 Asia Macro-Economic Indicators I

	Budget Deficit		Gross Domestic Savings		Gross Domestic Investment		Resource Balance		M2 / GDP	
	1972	1989	1965	1989	1965	1989	1965	1989	1965	1989
A Newly Industrialising										
Countries	1 3	6 9	10	43	22	35	-12	8	58 4	117 5
1 Singapore	-3 9	0 2	8	37	15	35	-7	3	11 1	50 3
2 South Korea										
B ASEAN-4	-2 5	-2 1	8	37	8	35	0	2	13 2*	30 2
1 Indonesia	-9 4	-2 6	24	34	20	30	4	4	26 3	117 4
2 Malaysia	-2 0	-2 8	21	18	21	19	0	-1	19 9	21 1
3 Philippines	-4 2	3 1	19	29	20	31	-1	-2	23 6	65 0
4 Thailand										
C South Asia	-1 9	-7 6	8	1	11	12	-4	-11	16 5	27 3
1 Bangladesh	-3 2	-6 7	15	21	17	24	-2	-3	23 7	45 6
2 India		-6 4		11 6		12 6		-1		
3 Myanmar	-1 2	-10 1		7	6	19	-6	-12	8 4	33 4
4 Nepal	-6 9	-7 0	13	11	21	18	-8	-6	40 7	37 5
5 Pakistan	-5 1	-7 5	13	12	12	21			32 3	38 6
6 Sri Lanka										

Sources

The World Bank, World Development Report 1991, Tables 9, 11 and 13
Asian Development Bank, Asian Development Outlook, Tables A7, A8

Notes

* 1980 figure
Not available

Table 7 Asia Macro-Economic Indicators II

	Inflation Rate		Foreign Debt / GNP		GNP Per Capita	ODA / GNP	Debt Service / Exports	
	1965-80	1980-89	1980	1989	1989	1989	1980	1989
A Newly								
Industrialising								
Countries	5 1	1 5	0	0	10 450	0 0	0	0
1 Singapore	18 4	5 0	48 7	15 8	4 400	0 3	19 7	11 4
2 South Korea								
B ASEAN-4	35 5	8 3	28 0	59 4	500	1 9	13 9	35 2
1 Indonesia	4 9	1 5	28 0	51 6	2 160	0 4	6 3	14 6
2 Malaysia	11 7	14 8	49 5	65 3	710	1 9	26 5	26 3
3 Philiopines	6 2	3 2	25 9	34 1	1 220	1 0	18 7	15 9
4 Thailand								
C South Asia	14 8	10 6	31 7	53 3	180	8 9	23 2	19 9
1 Bangladesh	7 5	7 7	11 9	24 0	340	0 7	[illegible]	26 4
2 India	11 9*	11 7*			200**		25 4	30 4
3 Myanmar	7 8	9 1	10 3	43 5	180	16 0	3 2	16 0
4 Nepal	10 3	6 7	42 5	46 9	370	2 8	18 0	23 2
5 Pakistan	9 4	10 9	46 1	73 5	430	7 9	12 0	17 8
6 Sri Lanka								

Source

World Bank, World Development Report 1991, Table 1, 20 and 24

Notes

- * Consumer Prices 1971-80 and 1981-90
- * and ** ADB, Asian Development Outlook 1991, Tables AI and A9
- Not available

Table 8 Asia Nominal Interest Rates of Banks, 1989
(Average Annual Percentage)

	Deposit Rate	Lending Rate
A Newly Industrialising Countries		
1 Singapore	3 21	6 21
2 South Korea	10 00	11 25
B ASEAN-4		
1 Indonesia	18 6	21 70
2 Malaysia	3 00	7 00
3 Philippines	14 13	19 27
4 Thailand	9 50	15 00
C South Asia		
1 Bangladesh	12 00	16 00
2 India		16 50
3 Myanmar	1 50	8 00
4 Nepal	8 50	15 00
5 Pakistan		
6 Sri Lanka	16 43	23 17*

Source World Bank, World Development Outlook 1991, Table 13

Note * Reported as 13 17 which seems to be an error
. Not available

Table 9 Asia Central Government Expenditure, 1989

	Defense %	Education %	Health %	Housing Welfare, etc %	Economic Services %	Other %	Total GNP
A Newly Industrialising Countries							
1 Singapore	21 2	19 0	5 2	13 8	16 0	24 8	23 3
2 South Korea	24 9	18 5	2 0	9 9	19 7	24 9	16 9
B ASEAN-4							
1 Indonesia	8 3	10 0	1 8	1 7		76 2	20 6
2 Malaysia*	8 2	18 9	4 5	7 0	18 9	42 0	30 1
3 Philippines	13 0	17 1	4 3	2 0	25 9	37 7	15 7
4 Thailand	17 8	19 3	6 3	5 3	20 4	30 9	15 1
C South Asia							
1 Bangladesh							
2 India	17 2	2 7	1 7	5 0	22 1	51 3	17 7
3 Myanmar	18 7	13 7	5 0	14 8	31 7	16 2	
4 Nepal	5 2	10 0	5 0	5 0	49 0	25 8	22 0
5 Pakistani**	29 5	2 6	0 9	8 7	34 5	23 8	21 5
6 Sri Lanka	5 4	10 7	6 2	15 1	20 6	42 0	29 8

Source World Bank, World Development Report, 1991, Table 11

Notes * and ** Table 4, 1988, ADB, Asian Development Report, Vol 9, No 1, 1991, p 51

Not available

Table 10 Asia Central Government Revenue, 1989

	Percentage of Total Current Revenue						Total GNP
	Taxes on Income Profit and Capital Gains	Social Security	Domestic Taxes on Goods and Services	Taxes on International Trade	Other Taxes	Non Tax Revenue	
A Newly Industrialising Countries							
1 Singapore	20 9	0 0	19 5	2 7	11 1	45 7	27 5
2 South Korea	34 8	4 4	32 4	10 9	5 5	12 2	18 1
B ASEAN-4							
1 Indonesia	55 9	0 0	24 5	5 6	5 7	8 3	18 4
2 Malaysia	28 6	0 8	20 3	18 0	2 5	29 8	26 3
3 Philippines	26 1	0 0	33 2	22 7	4 0	14 0	12 8
4 Thailand	20 6	0 0	45 4	22 2	3 2	8 6	17 9
C South Asia							
1 Bangladesh	11 7	0 0	33 2	31 5	7 1	16 5	8 8
2 India	13 5	0 0	35 5	26 7	0 4	23 9	15 4
3 Myanmar	9 5	0 0	27 7	15 9	0 0	46 8	
4 Nepal	11 7	0 0	36 1	30 5	5 6	16 2	9 5
5 Pakistan	10 8	0 0	33 4	32 9	0 2	22 7	17 8
6 Sri Lanka	11 0	0 0	48 1	28 5	4 1	8 3	21 6

Source World Bank, World Development Report 1991, Table 12

Note Not available

EXPORT-LED ECONOMIC GROWTH:

LESSONS FROM THE FAR EAST

Mohamed Ariff

EXPORT-LED ECONOMIC GROWTH:
LESSONS FROM THE FAR EAST

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1. INTRODUCTION

Among the developing countries, East Asian economies stand stall. Their economic performance during the last two decades has been very impressive in both quantitative and qualitative terms. For they have not only been registering GNP and growth rates consistently well above the world average, but also experiencing quality growth with high labor absorption and without increasing inequality. Consequently, some of them have joined the league of "advancing developing countries" (ADCs).

All this apparently associated with their rapid export expansion in sharp contrast with most other developing countries. The expansion of manufactured exports, in particular, has contributed much to the transformation of their economy with important structural changes which have rendered them "newly industrializing economies" (NIEs). Interestingly, resource-poor countries have performed better than resource-rich ones, with the latter tending to rest on their laurels and deteriorating terms of trade eating into the benefits of output growth in the primary sector

The relationship between exports and economic growth makes considerable theoretical sense A country can export a product only if it has a comparative or competitive advantage in its production. While comparative advantage stems mainly from resource and factor endowment, competitive advantage is largely associated with scale economies backed up by infrastructure and other support facilities. In either case, exports imply specialization in activities in a country is best without being constrained by the domestic market This in turn implies efficiency in resource allocation, ensuring highest possible returns of factors of production.

There is also some empirical support for the hypothesis that links high economic growth with that of exports. This is borne out particularly in the East Asian experience which suggests that the more successful exporters tend to enjoy a faster income growth.

All this, however, should not be interpreted to mean that exports are a panacea for economic underdevelopment. In this context, it is pertinent to raise a number of important questions: Is it exports per se or policy changes that facilitate the export orientation that really matter? Is the East Asian export-led economic growth sustainable? Can the East Asian model be emulated by others? An attempt is made in this paper to address these and other related issues.

2. SOME EMPIRICAL OBSERVATIONS

Without a doubt, East Asia is the economic powerhouse of the world, if its economic growth rate is anything to go by. The East Asian "tigers" have been growing at a much faster pace than others. East Asia has outshined other regions of the world in terms of export expansion as well. It thus appears that the rapid economic growth in East Asia may have much to do with their impressive export performance. Per capita income, per capita merchandise exports, per capita manufactured exports, export/GDP ratios and growth rates of merchandise exports especially manufactured exports are all generally much higher for countries in East Asia than those in South Asia, Latin America and Africa, as shown by the samples in Table 1.

Cross-country regressions show that per capita GDP and per capita merchandise exports for countries shown in Table 1 are positively correlated with an R^2 of 0.71, while the correlation between per capita GDP and per capita manufactured exports is even stronger with an R^2 of 0.87 exhibiting a steeper positive relationship[1].

The postulate that the growth of merchandise exports and that of GDP are positively related is supported by the East Asian experience, which suggests that countries with faster growth of exports tend to have a faster growth of GDP (Figure 1). A similar positive relationship between the growth rate of manufactured exports and that of GDP is also borne out by the East Asian experience, but this relationship seems to be relatively weak (Figure 2). This suggests that it is the growth of exports in general, not of manufactures in particular, that really matters. This observation is further corroborated by the findings that merchandise exports are as percentage of GDP is positively associated with GDP growth rates (Figure 3), but the share of manufactures in total exports is negatively related to GDP growth rates (Figure 4).

Employment growth and export growth are not positively related (Figure 5). This negative relationship is even more apparent when employment growth is regressed against that of manufactured exports (Figure 6). The statistical relationship between employment growth and export/GDP ratio is also negative (Figure 7). Likewise, employment growth is negatively related to the share of manufactured exports in total exports (Figure 8). These observations do cast some doubts about the capacity of export-led growth to generate employment opportunities. By contrast, employment growth in East Asia is positively and strongly related to GDP growth (Figure 9). This suggests that much of the employment generated in the East Asian countries are due to the internal dynamics of these economies. One may conclude on the basis of all this that the external sector provides only an impetus, but it takes all the domestic sector to dynamize it so that the economy gathers a momentum of its own.

The above results should however be interpreted with caution. Most of them are not at all statistically significant, mainly because the number of observations are very few. Time series analyses presented in Table 2-9 supplement these cross-country regressions. These time series regressions for each of the East Asian countries generally lend support to the findings based on cross-country regressions.

The fact that employment growth is not intimately related to export growth is not as surprising as it may seem at first sight. Exports growth tends to have a stronger impact on employment growth only in the initial stage. Once the surplus labor is mopped up, wages tend to rise. Rising wages force these economies

[1] In the first regression, $Y = 1205 + 0.7X$ where Y = per capita GDP, X = per capita merchandise exports. In the second regression, $Y = 1134 + 0.75XM$ where XM = per capita manufactured exports.

to opt for skilled- and technology-intensive activities which have a low labor content. Perhaps, a stronger relationship between employment growth and exports would show up itself, if the analyses were conducted for a much earlier period, i.e the 1960s for the Northeast Asian economies, and the 1980s for the Southeast Asian ones.

3. EXPORT-ORIENTED INDUSTRIALIZATION

In all East Asian economies, with the notable exception of Hong Kong, the import substitution phase had preceded export orientation In all these economies, import-substituting industries have continued to coexist with export-oriented ones except in Singapore where the import substitution phase was brief.

Export-oriented industrialization in Northeast Asia began to manifest itself in the early 1960s before it could spread to Southeast Asia in the 1970s. Japan was the source of inspiration for these eclectic economies, with Korea, Taiwan, and Hong Kong viewing themselves as the second generation of industrializing countries in the Far East and ASEAN countries as the third generation The East Asian economies have benefitted much from the demonstration and spillover effects emanating from Japan mostly through Japanese foreign direct investments.

Export-oriented industrialization was actively pursued in East Asia to generate employment, accelerate economic growth, increase foreign exchange earnings and diversify their economies. The East Asian experience has clearly shown that comparative advantage is always subject to changes with one country losing its comparative advantage in certain production overtime and developing comparative advantage in an entirely new set of products. Industries in which Japan had lost its competitive edge were taken up by Korea, Taiwan and Hong Kong before they were passed on to ASEAN countries with industrial upgrading taking place in higher echelons.

The introduction of new products and new technology has expedited the process, with the low-wage Southeast Asian economies emerging as the new players Thus, the stereotype of developing countries being primary producers no longer holds true in most parts of East Asia

Although these East Asian economies have vigorously pursued export-oriented industrialization, they have gone about it in different ways Southeast Asian economies have depended much less on foreign direct investments than the ASEAN countries in their export drive. Strong direct state interventions in Korea and Taiwan were in sharp contrast to Hong Kong's laissez faire approach. Conglomerates or jaebols have played a catalytic role under state patronage in Korea's export-oriented industrialization, whereas the main export thrust in Taiwan came from small and medium scale industries (SMIs). In the ASEAN sub-region, Free Trade Zones (FTZs) or Export Processing Zones (EPZs) have played a key role in Malaysia's export-oriented industrialization, whereas in Indonesia, the Philippines and Thailand they have had a relatively low profile.

Nonetheless, a common denominator for all of them has been liberal policy regimes that gave the private sector considerable leeway. These included adoption of liberal exchange rate policies, trade liberalization measures so as to encourage the flow of resources from the non-traded to the traded sector, and privatization of public enterprises. It is also noteworthy that the export drive was based on the adoption of sound macroeconomic policies designed to minimize the built-in distortions in the system in such a way as to reduce both external and internal imbalances.

As alluded to earlier, the "new tigers" in the ASEAN region have benefitted much from the demonstration effect emanating from the "old tigers" in Northeast Asia. The new tigers were inspired by the older ones whose experience had already shaken the foundation of the "export pessimism" school regarding the feasibility and desirability of export-led growth that was prevalent in the 1950s and 1960s. The newcomers grabbed the opportunity to move quickly to occupy the positions vacated by the old tigers whose very success had resulted in rising real wages forcing them into capital- and skill-intensive activities.

This process was aided by a fairly conducive international trading environment. The international trading environment was fairly liberal in the 1960s when the Northeast Asian NIEs began to adopt export-led growth strategies. Subsequent protectionist pressures were either effectively neutralized by circumvention or taken into account in industrial restructuring that led to industrial relocation elsewhere. It is in this sense that the newcomers did benefit from the industrial countries protectionism.

It is an open secret that NIEs have practiced transshipment (cheating on rules of origin) for undifferentiated products like textiles to beat the VERs (voluntary export restraints). In some cases where start-up costs were low, production was shifted to the neighbors not affected by VERs Korea and Taiwan had successfully used exchange rate policy for a long time to promote their exports. They were able to offset the protectionist pressures in the export market by keeping the external value of their currencies artificially low. Recent revaluation of the Korean won and the New Taiwanese dollar under international pressure has also benefitted the new tigers as it forced some industries to migrate out of the older ones.

It cannot be denied the GSP (Generalized System of Preferences) did help kick-start export-oriented industrialization in some countries even though the long-term benefits of GSP are dubious. Some foreign direct investments (FDI) in the ASEAN region were designed to take advantage of the GSP facility. In the same vein, developed country market access through MFAs (Multifibre Arrangements), have also attracted FDI into ASEAN.

Liberal policies adopted by ASEAN countries towards FDI have made export-oriented industrialization possible. Generous investment incentives, including tax holidays and 100 per cent equity participation in export-oriented manufacturing activities, have rendered them attractive offshore bases. It is, however, incorrect to attribute all this to investments incentives only. Perhaps, these incentives had served only as icings on the cake, for these countries have other inherent attractions which include political stability, good infrastructure facilities, and fairly efficient bureaucracy.

However, the process of reorientation of the manufacturing sector has been less smooth in some countries than in some others. Countries such as Malaysia and Thailand, where tariffs have been relatively low, have found it easier to reorientate their manufacturing sector than countries such as Indonesia and the Philippines where the import-substituting industries have been protected more heavily and over a longer period. High effective tariffs have tended to create a strong bias against exporting in these countries (Ariff and Hill, 1985). While powerful vested interests have resisted attempts at lowering the extent of protection accorded to domestic industries, political instability, especially in the Philippines, has obstructed policy reforms (Ariff, 1990).

It is interesting to observe that the anonymous market forces are integrating the East Asian region in an informal manner. Japanese, Taiwanese, and Korean investments in the region have generated much intra-regional and intra-industry trade flows. For example, Mitsubishi investments in the automotive sector have resulted in a regional division of labor, with Malaysia concentrating on the production of door panels and other stamped parts, Thailand specializing in the manufacture of fuel tanks, consoles, bumpers and windshields and the Philippines focusing on transmission parts. The Mitsubishi group sources automobile parts and component from a network of affiliates and subsidiaries in the region. In fact, all major Japanese automobile producers including Honda, Toyota, Nissan, Isuzu and Mazda have formed affiliates and subsidiaries in East Asia.

Another interesting observation relates to the emergence of "growth triangles" (GTs) by which is meant subregional economic zones encompassing three subregional networks of production processes in a borderless fashion. GTs act as a "production bloc" that renders the products internationally competitive. The most well-known growth triangle is the SIJORI (Singapore-Johor-Riad) triangle in the ASEAN subregion. Other examples are the Bhat zone (Thailand-Kampuchea-Laos) the Yellow Sea triangle (Korea-China-Mongolia).

4. PROGNOSIS AND PROSPECTS

It would seem that export-led growth in East Asia would deepen their dependency status and render their economies vulnerable to external vagaries. While export instability in the face of external volatility will have domestic consequences, the East Asian experience has shown that the adverse impact is not as severe as it would appear prima facie. The East Asian economies have been remarkably resilient, registering creditable growth even when the industrial countries have slowed down significantly. Domestic dynamics coupled with prudent macroeconomic management have helped cushion the impact of external fluctuations which are transmitted through the export channels.

The long-term prospects however would hinge critically on whether or not the multilateral trading system will continue to exist. The slow pace at which the Uruguay Round has progressed since it was launched in 1986 and the emergence of economic regionalism in Europe and North America may not augur well. This however need not be interpreted to mean that the multilateral trading system is about to collapse. One cannot write off the Uruguay Round as a failure, considering the enormously difficult tasks it has taken upon itself, nor can one expect the Uruguay Round to provide solutions to all problems associated with international trade. If the Uruguay Round can take us beyond the previous Tokyo Round and pave the way for subsequent rounds of negotiation, we shall have something to cheer about at the end of the day.

In the same vein, the formation of regional groupings such as NAFTA (North American Free Trade Area) and SEM (Single European Market) need not necessarily imply the end of the GATT (General Agreement on Tariff Trade) system so long as they remain GATT-consistent. If such group formations can lead to greater economic efficiency and render their products internationally competitive, inter-regional trade can flourish.

Export pessimism expressed by Prebisch (1952) and Nurkse (1959) has not been thrown out the window despite the successful export thrusts of the East Asian NIEs. Export promotion by LDCs was viewed negatively in the 1950s in the belief that it would cause significant deterioration in the terms of trade and that the foreign markets could not simply absorb increased LDC exports. The East Asian NIEs have shown that this perception was incorrect. Much would, however, depend on whether the East Asian experience is an exception or the rule.

The new debate on export pessimism revolves around the generalization of the East Asian model in the light of perceived protectionist trends in developed countries. It is contended that an emulation of the East Asian model by other LDCs would generate increased pressure in developed country markets resulting in more and more protectionist interventions (Cline, 1982).

The above argument, however, does not hold water upon close scrutiny, for it presupposes that LDCs will flood the market with their exports all at once. It would be more realistic to expect that different LDCs will reach the substantial manufacturing export capacity at different points in time (Ranis, 1985). If their entry is sufficiently staggered, the pressure generated may not be as spectacular as feared. Such pressures may also be diffused greatly, if LDC exports exhibit considerable diversity in terms of both variety and quality. Besides, there is still a vast room for LDC export expansion before it could trigger strong reactions in developed countries, considering the fact the LDC share in the industrial countries' consumption of manufactures, is just over 2 per cent (Bhagwati, 1988).

The fear of a backlash from developed countries completely ignores the possibility of increased LDC imports from developed countries. For increased exports imply increased imports not only of intermediate outputs for export production but also of consumer goods due to higher incomes. It is pertinent to also note that the only reason, in the ultimate analysis, why an LDC would want to export is that it wants to import. Thus, increased exports matched by increased imports should open up more avenues for trade floors, instead of unleashing protectionist forces.

The export pessimism hypothesis assumes that all exports will be targeted at the developed country markets only. This need not be the case. A significant proportion of the LDC exports may be directed at other LDCs. Since export-promoting trade strategy calls for a more open trading regime, one can expect increased South-South trade.

While it cannot be denied that protectionism is unmistakably on the rise in developed countries, there is no basis for LDCs to be unduly pessimistic about their export prospects. For one thing, many of the protectionist measures especially VERs are so porous that markets are kept more open than they seem (Baldwin, 1982). For another, the increased globalization of industries with foreign direct investments criss-crossing the world economy, referred to as the "spiderweb" phenomenon in the literature (Bhagwati, 1988), and the growing trade-investment linkages tend to create strong pro-trade constituencies that would help contain the protectionist forces especially in developed countries.

5. POLICY ISSUES

Terminologies have sometimes contributed to unnecessary policy confusion. Export promotion does not necessarily imply a bias in favor of exports. The export promotion connotes no more than a policy that is neutral in its bias between production for export and that for domestic consumption (Bhagwati, 1978, Krueger, 1978). Seen in these terms, export distortions, such as the incentives for export and import-substituting activities are equalized. This definition was subsequently adopted by the World Bank in the *World Development Report 1987*.

The export drive of the East Asian economies has not conformed neatly to the above description. The question of equalizing the bias in favor of export and domestic market oriented activities did not arise in Hong Kong since there was no bias in either direction in the first place. In Singapore, there is no bias in favor of import-substituting activities to be neutralized by similar incentives for export activities. Investment incentives offered by Singapore thus seem to have a natural bias in favor of exports. Korea and Taiwan have fanatically protected their domestic industries while vigorously promoting their exports in a mercantile fashion. The ASEAN-4 (Indonesia, Malaysia, the Philippines and Thailand), like Korea and Taiwan, have pursued both EP and IS strategies simultaneously, but the degree of protection has been significantly lower than that of Korea and Taiwan. The anti-export bias present in the structure of protection has been offset by export incentives. They have thus seemingly adopted a "neutral" trade regime by "neutralizing" the distortions caused by their structure of protection.

To be sure, export incentives cause distortion just like tariffs, and all distortions are objectionable. The first-best solution would be to eliminate the distortions at the source and not to offset one set of distortions with another set in the opposite direction. There is also the danger of the anti-export bias being more than offset by export incentives. The fact that several Korean and Taiwanese export items were subjected to U.S. countervailing duties suggests that exports may have indeed been over-subsidized.

Although the trade regimes in most parts of East Asia are not truly neutral, they have all tended to adopt liberal economic policies in general. For export orientation has necessitated decontrol and deregulation to a great extent. Such liberal policies can lead to both static and dynamic gains. Seen in this perspective, it is not difficult to understand why export expansion has tended to act as an "engine of growth". This observation implies that it is not export-orientation per se but liberal policies behind it that is largely responsible for the growth impulse in the East Asian Economies. The fact that exports account for a relatively small proportion of the GNP in many of these economies lends credence to this view.

The East Asian experience shows that "promotion" works better than "protection". Industries that are promoted tend to be more efficient than those that are protected. Incentives generally yield better results than controls. This is not to deny that export incentives too distort prices just like tariffs and import controls. Nonetheless, the infant industry argument can be invoked more forcefully to justify support for the export-oriented industry than for the import-substituting one. The safety valve is that an inefficient industry cannot survive for too long in the open international market despite government support, quite unlike an inefficient industry serving a sheltered domestic market.

Much however depends on the form of export assistance. It has been shown that the appropriate policy would be to subsidize the source of gains in output, e g. development of labor skills and acquisition of technology (Baldwin, 1969). Export subsidy that simply reduces the prices of exports to be competitive in the international market is objectionable, as it subsidizes not the source of output gains but the consumption of rich foreigners, and worsens the country's terms of trade.

It is, of course, possible to overdo export promotion. In this context, export processing zones have been subject to much criticism, most of which however revolves around non-economic issues such as working conditions. Cost-benefit studies show that EPZs in Malaysia have fared much better than those in the Philippines or Indonesia (Spinanger, 1984 and Warr, 1983). EPZs in China, where they are called "Special Economic Zones" have also fared fairly well (Wu, Wang, and Gu, 1989). Be all that as it may, there is little doubt that EPZs have generated substantial employment opportunities and that wages in these zones are generally higher than those outside the zones, despite the fact EPZ labor is not unionized (Ariff and Hill, 1985).

A serious criticism leveled against EPZs relates to the enclave nature of their operation with hardly any linkages with the rest of the economy. Manufactured exports have higher import content than manufactures as a whole, since inputs are admitted duty-free for export-oriented industries, especially in the case of EPZ industries. This criticism seemed particularly serious in the initial years when local content hardly exceeded 5 per cent (Ariff, 1989). But, over the years, however, local content has increased significantly.

In any case, high linkages (i.e. high local content) per se are not necessarily desirable. In fact, the opposite may be more valid, for the dynamism of Singapore's manufacturing sector may have much to do with its high import content, in sharp contrast to Indonesia's inefficient industries with high domestic content. High domestic content arising from local linkages may lead to increased costs and render the export product uncompetitive internationally.

EPZs have also been criticized for being footloose. The East Asian experience, however, lends no support to this perception. EPZs in East Asia, especially those in Malaysia have remained rooted. The emergence of ancillary activities, such as subcontracting with SMIs, has anchored the MNCs and EPZs firmly.

The establishment of EPZs amounts to liberalizing a segment of the economy so that it is not subject to the controls and regulations of the country. A logical sequence will be to extend this by liberalizing the rest of the economy as well EPZs can thus function as a free market economy experiment. This indeed seems to be the trend especially in China, where the Special Economic Zones are proliferating along the east coast. In a similar vein, the whole of Singapore can be considered a single huge EPZ.

6. REPLICABILITY OF THE EAST ASIAN EXPERIENCE

Is the East Asian export-led growth model applicable to other LDCs? To be sure, there is no simple answer to this question. The answer may have little to do with export prospects as such. Much will depend not only on which LDC one is talking about but also on what one means by the term the "East Asian model".

As observed earlier, export pessimism is not the real concern. There is always room for eclectic countries that are determined to make a dent in the international market. Exports can provide no way out for countries which are bogged down by supply constraints of sorts. For countries that are resource-rich with huge domestic markets, manufactured exports may need to play only a marginal role, provided they could generate internal dynamism by adopting appropriate policies. Not many LDCs possess the kind of generic skills and capabilities which have enabled the East Asian tigers to launch and sustain their export drive.

There is no such thing as the East Asian model. In fact, there are as many models as there are countries. The Korean model has relied heavily on strong government support for mega enterprises which have played a critical role in the country's export thrust, while in the Taiwanese model state interventions have been aimed at promoting SMIs which have played a catalytic role in its export drive. By contrast, the Hong Kong model strongly resembles the text-book version of a laissez-faire economy where market forces have steered the economy to greater heights. In the Singapore model, the state has played a pervasive developmental role, with the long arm of the state working with, not against, market forces. Elsewhere in ASEAN, public and private sectors have played catalytic roles, pursuing socio-economic objectives with some trade-offs. The Northeast Asian economies have relied much less on foreign direct investments, quite unlike their Southeast Asian counterparts.

A common feature in all these cases has been the absence of bias against exporting. In other words, the essence of the so-called East Asian model lies not so much in the East Asian countries' successful export initiatives as in their success in eliminating the anti-export bias that was previously present in their policy regimes. Seen in these terms the key to economic success was not export orientation but 'other things' that go with it such as deregulation, prudent monetary fiscal policies, realistic exchange rates, tariff reforms, liberal policies towards foreign investment, etc.

Export orientation matters only to the extent that it necessitates bold policy initiatives. However, it is quite possible for a country to initiate such policy maneuvers without having to resort to export orientation in a big way. The latter is critical and crucial only for small economies like Singapore and Hong Kong, given their domestic market constraints. For big countries like India and Brazil where such constraints are not severe, an inward-looking strategy with fairly liberal economic policies and minimum government interventions can probably facilitate rapid growth.

The East Asian model is applicable elsewhere to the extent that it constitutes a liberal approach that gives the market forces considerable leeway and is perceived as a "neutral" regime that does not discriminate between export and domestic markets rather than as one with a bias in favor of exports, i.e., a trade regime in which the effective exchange rates for importable and exportable commodities are equalized.

To be sure, producing for the export market is a lot tougher than producing for the home market. Developed country consumers are more discerning and demanding than their local counterparts The product has to be internationally competitive in terms of both price and quality, which few LDCs can measure up to. It also requires marketing skills that many LDCs lack. What is more, the product has to overcome the protectionist barriers in the export markets. Needless to say, all this would be an uphill task for a newcomer. ASEAN countries have been able to overcome these problems by playing host to MNCs which have the modern technology, industrial experience and marketing network. This has warranted liberal policies towards foreign investments.

The above strategy, however, would work only if the host country has certain necessary pre-requisites such as political stability, industrial peace, educated and disciplined work force, local pool of entrepreneurship, efficient bureaucracy, policy consistency and predictability, good infrastructure, and benign, strong government that is committed to development. If not, a country will neither be able to attract foreign direct investments nor be ready to internalize the benefits on a sustainable basis through technology transfers, skill development, marketing know-how, industrial upgrading and the like.

Cheap labor alone is not sufficient to attract export-oriented foreign direct investments, as labor cost constitutes only a small proportion of the total cost of production even in labor-intensive activities. The low labor cost advantage may be lost due to, say, high transport and transaction costs. Besides, low wages may not mean low labor cost if labor productivity is also low Thus, it is not surprising that MNCs do not shift their labor-intensive assembly activities, simply because wages have risen substantially, to other countries where wages are low.

In any case, it appears that FDI flows are slowing down. There are indications that more and more Japanese, Korean and Taiwanese capital will be invested at home and that less and less will be available for investments overseas. European and North American capital outflows are also likely to slow down with the emergence of the SEM and NAFTA. These regional groupings may also divert investments from the rest of the world. Marketization in Russia and East European countries will suck in FDIs Liberal open-door policies in many developing countries including India and Pakistan will also add to the scramble. All this suggests that one cannot depend on FDI Even in East Asia, where FDI apparently has played an important role, it accounts for a relatively small proportion of the total investments. In other words, countries must generate their own savings, and FDI should be seen only as a supplement, not a substitute, for domestic investment

Although it is generally true that economic success and social progress are mutually reinforcing, there is no guarantee that export-led growth will result in better economic welfare for all. If Korea and Taiwan have registered quality growth without sacrificing equity, it was partly because they have both had thorough and successful agrarian reforms.

The above analysis suggests that it is not easy for an average LDC to emulate the East Asian economies in terms of export-led growth. However, the essence of the East Asian experience, as pointed out earlier, lies not in their successful export drive but in their bold liberalization measures. In this regard, there are certainly lessons for LDCs in the East Asian experience. In the final analysis, each country needs to develop its own growth model, rather than ape that of others. In developing its own model, a country can draw lessons from the experience of others. It is in this sense that the East Asian experience is useful and relevant to other LDCs.

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TABLE I

EXPORT-GDP GROWTH RELATIONSHIP: SELECTED COUNTRIES

Country	Per Capita GDP (US$) 1990	GDP Growth Rate (%) 1987-89	Per Capita Merchandise Exports (US$) 1990	Total Merchandise Exports (mil US$) 1990	Export Growth Rate (%) 1987-90	Export /GDP Ratio (%) 1990	Total Manufactured Exports (mil US$) 1990	Manufactured Export Growth Rate (%) 1987-90	Per Capita Manufactured Exports (US$) 1990
North-east Asia									
China	321.9	7.5	54.8	62091	16.2	17.0	45326.4	17.9	40.0
South Korea	5523.4	8.8	1514.9	64837	11.2	27.4	60946.8	12.0	1424.0
Taiwan		-	3318.1	67025	9.7	41.9	62333.3	9.7	3085.8
Hong Kong	1028[illegible]	5.0	5000.3	29002	19.2	137.7	78873.6	20.9	13598.9
South-east Asia									
Indonesia	602.1	6.6	143.4	25553	14.1	23.8	8943.6	24.4	50.2
Malaysia	2368.7	8.9	1643.0	29409	18.1	69.4	12940.0	21.9	722.9
Philippines	713.2	6.0	141.2	8681	15.4	19.8	5382.2	15.4	87.5
Singapore	11533.3	10.2	17542.3	52627	22.6	152.1	38417.7	23.1	12805.9
Thailand	1436.7	12.7	412.2	23002	25.4	28.7	14721.3	33.6	263.8
South Asia									
India	299.6	7.3	21.2	17967	12.7	7.1	13115.9	14.8	15.4
Pakistan	315.8	5.0	49.7	5590	10.2	15.7	3913.0	11.9	34.8
Bangladesh	214.4	4.6	15.7	1674	15.9	7.3	1222.0	31.5	11.5
Sri Lanka	426.5	2.4	116.7	1984	12.5	27.4	952.3	19.6	56.0
Latin America									
Argentina	2887.3	-3.6	382.4	12353	24.8	13.2	4447.1	31.1	137.7
Brazil	2753.1	-	207.7	31243	6.0	7.5	16558.8	12.0	110.1
Chile	2105.3	8.7	649.9	8579	19.0	30.9	857.9	23.3	65.0
Colombia	1273.1	3.6	209.5	6766	10.4	16.5	1691.5	17.0	52.4
Africa									
Ivory Coast	639.5	-	218.5	2600	-4.5	34.2	260.0	-1.1	21.8
Kenya	311.6	5.3	42.7	1033	2.4	13.7	113.6	-11.4	4.7
Zimbabwe	541.8	5.9	136.8	1300	-2.2	24.5	572.0	1.7	60.2
Nigeria	301.0	-	118.4	13671	22.9	39.3	-	-	-
Ghana	420.8	-	49.6	739	-11.2	11.8	7.4	-29.5	0.5

N.B. GDP growth rates are real, based on constant price GDP data.
Others are based on data at current prices.

For Zimbabwe, total and per capita merchandise exports and manufactured exports refer to 1989, growth rates of merchandise exports and manufactured exports refer to 1987-89.

Source: Asian Development Bank, Asian Development Outlook 1991.
International Monetary Fund, International Financial Statistics, November 1992.
United Nations, National Accounts Statistics: Main Aggregates and Detail Tables, 1989.
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TABLE 2

GROWTH OF GDP AND EXPORTS

$Y = a + b X$

Y = GDP Growth Rate

X = Growth Rate of Merchandise Exports

	a	b	R^2	No. of observ.	Years
North-east Asia					
China	4.63	0.16	0.29	14	1976-89
Hong Kong	3.17	0.26	0.54	19	1971-89
Korea, Rep. of	8.21	0.01	0.01	19	1971-89
Taiwan	-	-	-	-	-
South-east Asia					
Indonesia	5.97	0.04	0.24	19	1971-89
Malaysia	6.39	0.08	0.09	19	1971-89
Philippines	4.21	-0.01	0.001	19	1971-89
Singapore	6.47	0.09	0.20	19	1971-89
Thailand	5.85	0.06	0.07	19	1971-89

Source: International Monetary Fund, International Financial Statistics, May 1977 - November 1992.

United Nations, National Accounts Statistics: Main Aggregates and Detail Tables, 1989.

United Nations, National Accounts Statistics: Analysis of Main Aggregates, 1988-89.

TABLE 3

GROWTH OF GDP AND MANUFACTURED EXPORTS

$Y = a + b X$

Y = GDP Growth Rate

X = Growth Rate of Manufactured Exports

	a	b	R^2	No. of observ.	Years
North-east Asia					
China	8.47	-0.01	0.01	11	1977-89
Hong Kong	8.40	0.06	0.10	12	1976-89
Korea, Rep. of	6.76	0.10	0.15	12	1976-89
Taiwan	-	-	-	-	-
South-east Asia					
Indonesia	5.97	0.01	0.03	12	1976-89
Malaysia	6.75	0.02	0.01	12	1976-89
Philippines	2.43	0.09	0.66	12	1976-89
Singapore	6.90	0.06	0.17	12	1976-89
Thailand	7.38	0.03	0.03	12	1976-89

N.B. Data exclude 1984 and 1985.

Source: International Monetary Fund, International Financial Statistics, May 1977 - November 1992.

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World Bank, World Development Reports, 1978-92.

TABLE 4

GDP GROWTH AND EXPORT-GDP RATIO

Y = a + b X

Y = GDP Growth Rate

X = Merchandise Exports as percentage of GDP

	a	b	R^2	No. of observ.	Years
North-east Asia					
China	5.41	0.34	0.07	15	1975-89
Hong Kong	5.47	0.02	0.004	9	1981-89
Korea, Rep. of	6.14	0.09	0.03	19	1971-89
Taiwan					
South-east Asia					
Indonesia	-2.33	0.34	0.10	9	1981-89
Malaysia	13.90	-0.13	0.04	19	1971-89
Philippines	-0.52	0.30	0.02	19	1971-89
Singapore	9.95	-0.01	0.01	19	1971-89
Thailand	0.41	0.36	0.19	19	1971-89

Source: International Monetary Fund, International Financial Statistics, May 1977 - November 1992.

United Nations, National Accounts Statistics: Main Aggregates and Detail Tables, 1989.

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TABLE 5

GDP GROWTH AND SHARE OF MANUFACTURES IN TOTAL EXPORTS

$Y = a + b X$

Y = GDP Growth Rate

X = Manufactured Exports as percentage of Merchandise Exports

	a	b	R^2	No. of observ.	Years
North-east Asia					
China	7.82	0.01	0.002	12	1977-89
Hong Kong	-22.32	0.33	0.03	14	1975-89
Korea, Rep. of	6.00	0.03	0.0005	14	1975-89
Taiwan					
South-east Asia					
Indonesia	6.22	-0.02	0.01	14	1975-89
Malaysia	6.75	-0.02	0.005	14	1975-89
Philippines	8.08	-0.09	0.18	14	1975-89
Singapore	4.68	0.04	0.02	14	1975-89
Thailand	4.07	0.11	0.17	14	1975-89

N.B. Data exclude 198'.

Source: Internatio l Monetary Fund, International Financial Statistics, Nover er 1992.

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TABLE 6

GROWTH OF EMPLOYMENT AND EXPORTS

Y = a + b X

Y = Employment Growth Rate

X = Growth Rate of Merchandise Exports

	a	b	R-squared	No. of observ.	Years
North-east Asia					
China	2.57	0.01	0.02	14	1978-91
Hong Kong	0.99	0.08	0.14	13	1979-91
Korea, Rep. of	2.33	0.03	0.13	19	1971-91
Taiwan	-	-	-	-	-
South-east Asia					
Indonesia	5.75	-0.24	0.87	5	1986-90
Malaysia	2.90	0.04	0.18	20	1971-90
Philippines	4.30	-0.04	0.03	20	1971-90
Singapore	2.91	0.05	0.06	18	1974-91
Thailand	4.06	-0.02	0.01	17	1972-88

Source: Malaysia, Ministry of Finance, Economic Reports, 1987-92.

International Labour Office, Year Books of Labour Statistics, 1980, 1986, 1992.

International Monetary Fund, International Financial Statistics, May 1977 - November 1992.

TABLE 7

GROWTH OF EMPLOYMENT AND MANUFACTURED EXPORTS

$Y = a + b X$

Y = Employment Growth Rate

X = Growth Rate of Manufactured Exports

	a	b	R^2	No. of observ.	Years
North-east Asia					
China	2.62	0.003	0.01	11	1978-90
Hong Kong	1.49	0.06	0.21	10	1979-90
Korea, Rep. of	1.99	0.05	0.28	13	1976-90
Taiwan	-	-	-	-	-
South-east Asia					
Indonesia	6.93	-0.11	0.01	5	1986-90
Malaysia	4.24	-0.02	0.04	13	1976-90
Philippines	2.15	0.05	0.03	13	1976-90
Singapore	2.09	0.07	0.52	13	1976-90
Thailand	2.28	0.07	0.06	11	1976-88

N.B. Data exclude 1984 and 1985.

Source: Malaysia, Ministry of Finance, Economic Reports, 1987-92.

International Labour Office, Year Books of Labour Statistics, 1980, 1986, 1992.

International Monetary Fund, International Financial Statistics, May 1977 - November 1992.

World Bank, World Development Reports, 1978-92.

TABLE 8

EMPLOYMENT GROWTH AND EXPORT-GDP RATIO

Y = a + b X

Y = Employment Growth Rate

X = Merchandise Exports as percentage of GDP

	a	b	R^2	No. of observ.	Years
North-east Asia					
China	2.38	0.56	0.03	12	1978-89
Hong Kong	6.82	-0.05	0.17	11	1981-91
Korea, Rep. of	4.38	-0.05	0.03	21	1971-91
Taiwan	-	-	-	-	-
South-east Asia					
Indonesia	32.26	-1.27	0.99	5	1986-90
Malaysia	3.11	0.01	0.002	20	1971-90
Philippines	13.47	-0.64	0.09	20	1971-90
Singapore	-5.58	0.07	0.13	18	1974-91
Thailand	-0.45	0.22	0.02	17	1972-88

Source: Malaysia, Ministry of Finance, Economic Reports, 1987-92.

International Labour Office, Year Books of Labour Statistics, 1980, 1986, 1992.

International Monetary Fund, International Financial Statistics, May 1977 - November 1992.

United Nations, National Accounts Statistics: Main Aggregates and Detail Tables, 1989.

United Nations, National Accounts Statistics: Analysis of Main Aggragates, 1988-89.

TABLE 9

EMPLOYMENT GROWTH AND SHARE OF MANUFACTURES IN TOTAL EXPORTS

$Y = a + b X$

Y = Employment Growth Rate

X = Manufactured Exports as percentage of Merchandise Exports

	a	b	R^2	No. of observ.	Years
North-east Asia					
China	2.97	-0.003	0.001	12	1978-90
Hong Kong	-27.59	0.32	0.08	11	1979-90
Korea, Rep. of	-1.52	0.05	0.01	15	1975-90
Taiwan	-	-	-	-	-
South-east Asia					
Indonesia	18.31	-0.49	0.61	5	1986-90
Malaysia	4.03	-0.02	0.01	15	1975-90
Philippines	4.13	-0.02	0.004	15	1975-90
Singapore	5.28	-0.04	0.03	15	1975-90
Thailand	2.51	0.05	0.01	13	1975-88

N.B. Data exclude 1984.

Source: Malaysia, Ministry of Finance, Economic Reports, 1987-92.

International Labour Office, Year Books of Labour Statistics, 1980, 1986, 1992.

World Bank, World Development Reports, 1978-92.

APPENDIX TABLE 1

Merchandise Exports as a percentage of GDP

	1987	1988	1989	Average 1987-89
China	11.4	10.9	10.3	10.9
Korea, Rep. of	35.1	34.1	29.0	32.7
Malaysia	56.2	60.1	66.2	60.8
Philippines	16.6	18.1	17.6	17.4
Singapore	135.7	154.9	152.5	147.7
Thailand	24.1	26.5	28.5	26.4
Hong Kong	102.4	113.6	116.3	110.8
Indonesia	22.7	23.2	24.4	23.4
Taiwan	52.7	49.3	44.9	49.0

Source: Asian Development Bank, Asian Development Outlook, 1989, 1990 & 1991.

APPENDIX TABLE 2

Manufactured Exports as a percentage of Merchandise Exports

	1987	1988	1989	Average 1987-89
China	70	73	70	71.0
Korea, Rep. of	92	93	93	92.7
Malaysia	40	45	44	43.0
Philippines	62	62	62	62.0
Singapore	72	75	73	73.3
Thailand	53	52	54	53.0
Hong Kong	92	91	96	93.0
Indonesia	27	29	32	29.3
Taiwan	93	92	93	92.7

Source: World Bank, World Development Reports, 1978-92.

APPENDIX TABLE 3

Growth Rate of Merchandise Exports (%)

	1987	1988	1989	1987-89
China	35.5	20.2	10.3	15.2
Korea, Rep. of	27.1	14.2	-5.7	3.8
Malaysia	28.0	22.2	22.7	22.5
Philippines	19.4	27.5	14.0	20.6
Singapore	23.0	31.2	10.4	20.3
Thailand	29.2	33.9	27.9	30.9
Hong Kong	36.8	30.3	15.8	22.8
Indonesia	6.6	13.6	13.8	13.7
Taiwan	35.4	12.4	9.4	10.9

Source: International Monetary Fund, International Financial Statistics, May 1977 - November 1992.

APPENDIX TABLE 4

Growth Rate of Manufactured Exports (%)

	1987	1988	1989	1987-89
China	48.3	25.4	5.8	15.2
Korea, Rep. of	28.5	15.4	-5.7	4.3
Malaysia	42.3	37.5	20.0	28.4
Philippines	21.3	27.5	14.0	20.6
Singapore	30.3	36.6	7.4	21.2
Thailand	63.0	31.3	32.9	32.1
Hong Kong	36.8	28.9	22.2	25.5
Indonesia	30.8	22.0	25.6	23.8
Taiwan	38.4	11.2	10.6	10.9

Source: International Monetary Fund, International Financial Statistics, May 1977 - November 1992.
World Bank, World Development Reports, 1978-92.

APPENDIX TABLE 5

Real GDP Growth Rates (%)

	1987	1988	1989	1987-89
China	10.4	11.2	3.9	7.5
South Korea	12.0	11.4	5.6	8.5
Malaysia	5.4	8.9	8.9	8.9
Philippines	4.6	6.4	5.6	6.0
Singapore	9.5	11.2	9.2	10.2
Thailand	9.4	13.2	12.2	12.7
Hong Kong	14.0	7.9	2.3	5.0
Indonesia	5.0	5.7	7.3	6.5

Source: United Nations, National Accounts Statistics: Main Aggregates and Detail Tables, 1989.
United Nations, National Accounts Statistics: Analysis of Main Aggregates, 1988-1989.

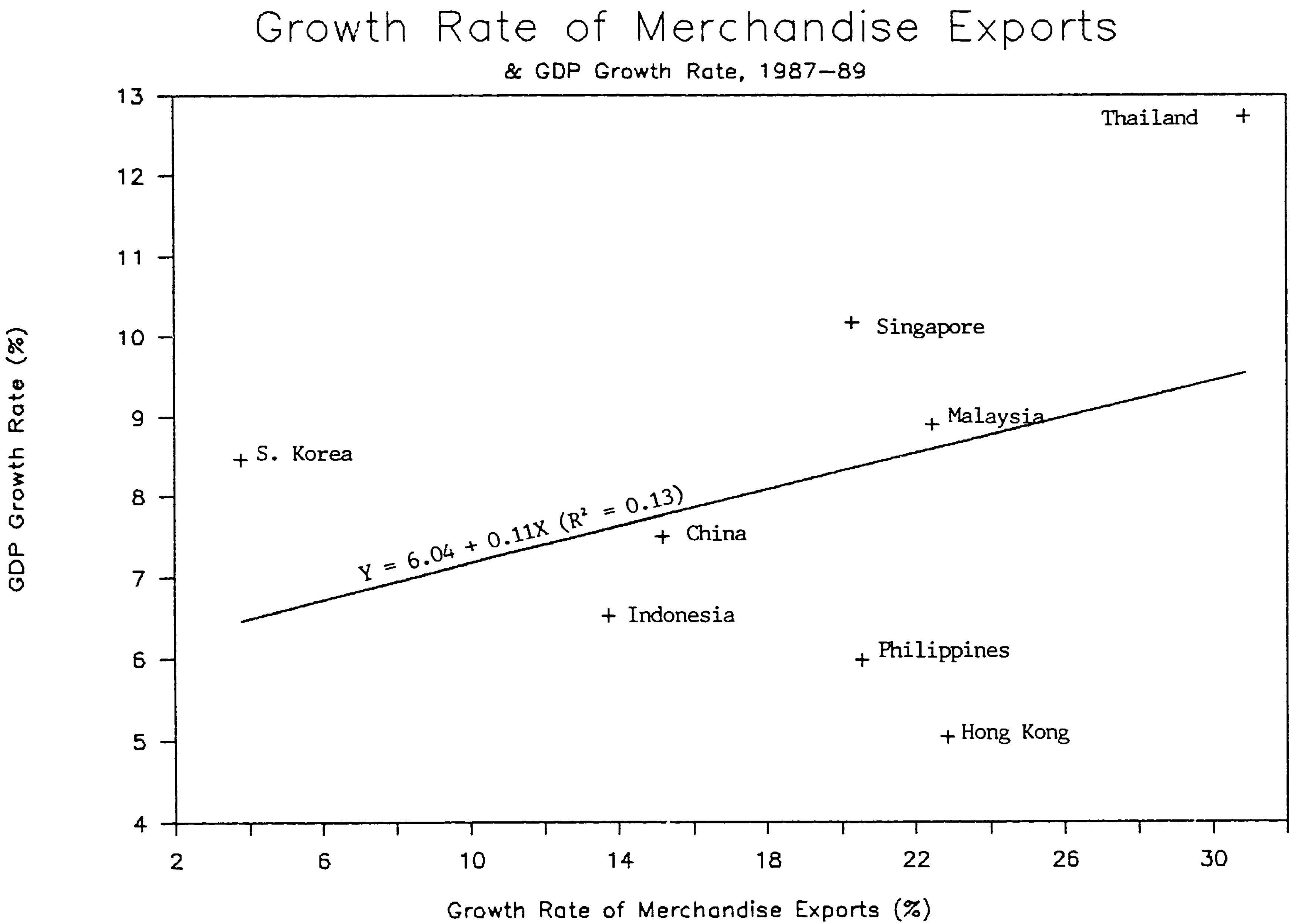
APPENDIX TABLE 6

Employment Growth Rate (%)

	1987	1988	1989	1987-89
China	2.9	2.9	1.8	2.4
Korea, Rep. of	5.5	3.2	3.8	3.5
Malaysia	3.1	3.5	4.3	3.9
Philippines	-0.6	3.4	1.6	2.5
Singapore	3.8	3.8	3.1	3.5
Hong Kong	2.4	1.9	0.3	1.1
Indonesia	3.0	3.0	1.3	2.1
Thailand	3.6	6.6	-	-

Source: International Labour Office, Year Books of Labour Statistics, 1980-92.
Malaysia, Ministry of Finance, Economic Reports, 1987-92.

FIGURE 1

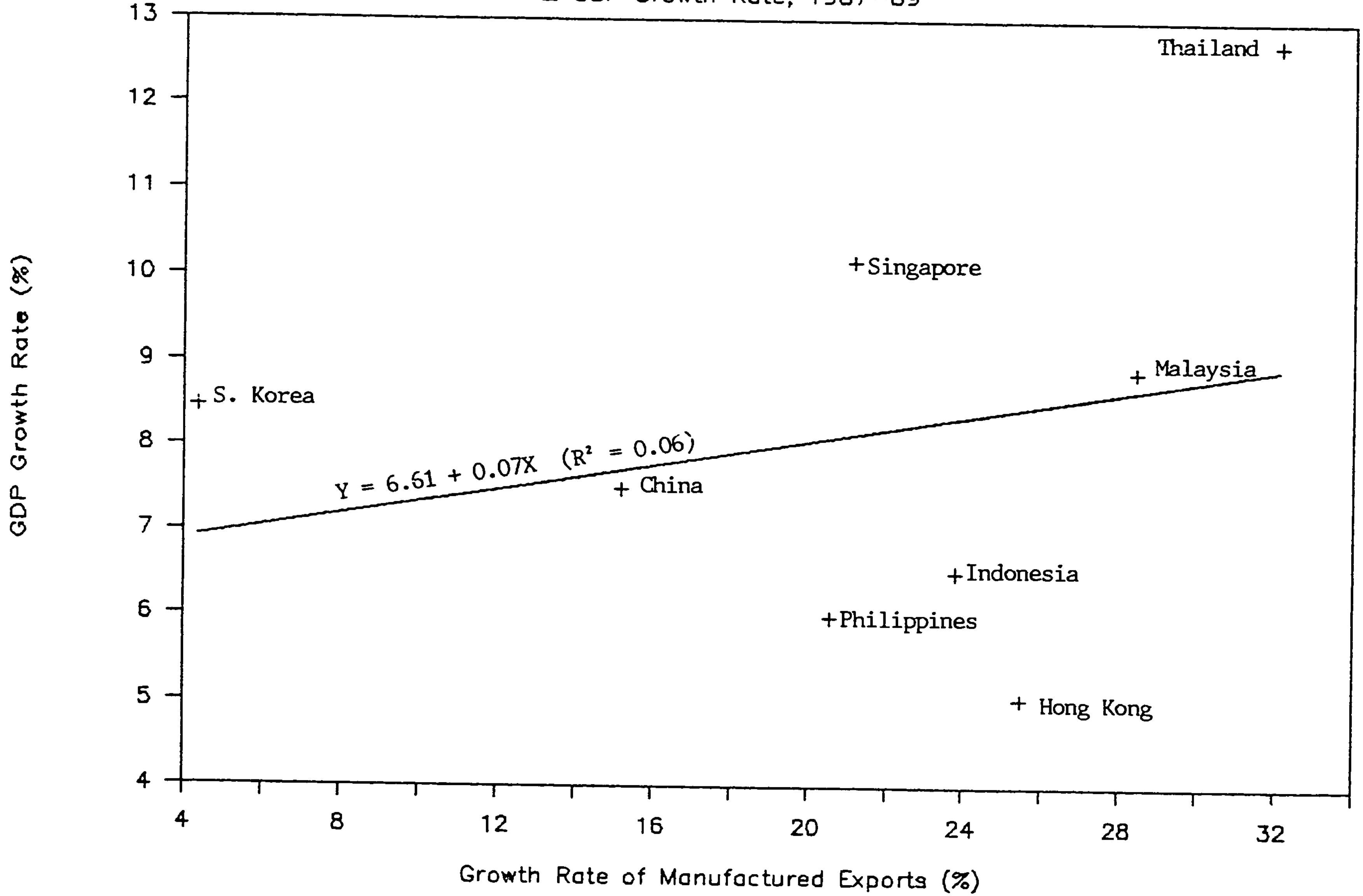


(real gdp growth rates
data of exports at current prices).

FIGURE 2

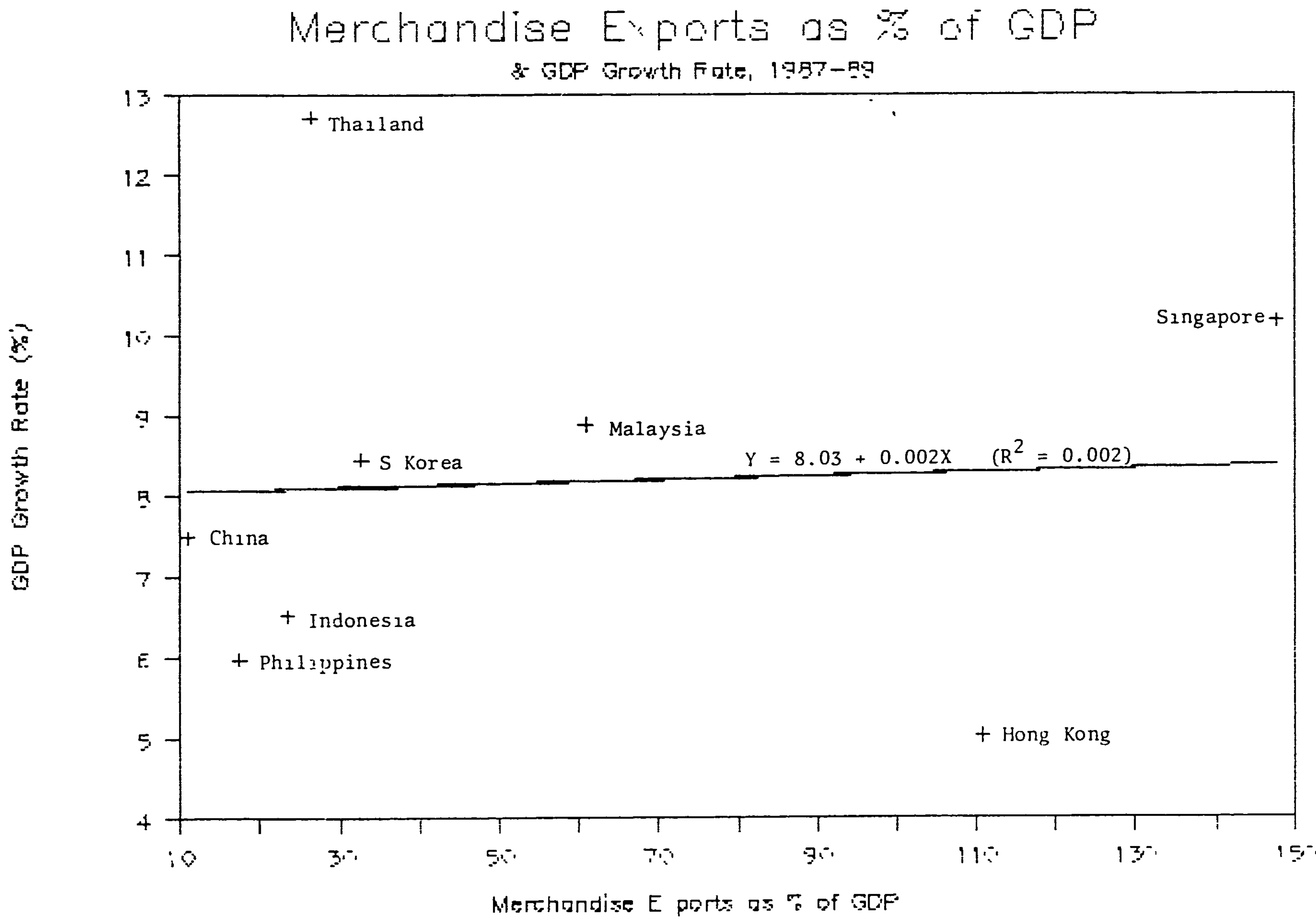
Growth Rate of Manufactured Exports

& GDP Growth Rate, 1987–89



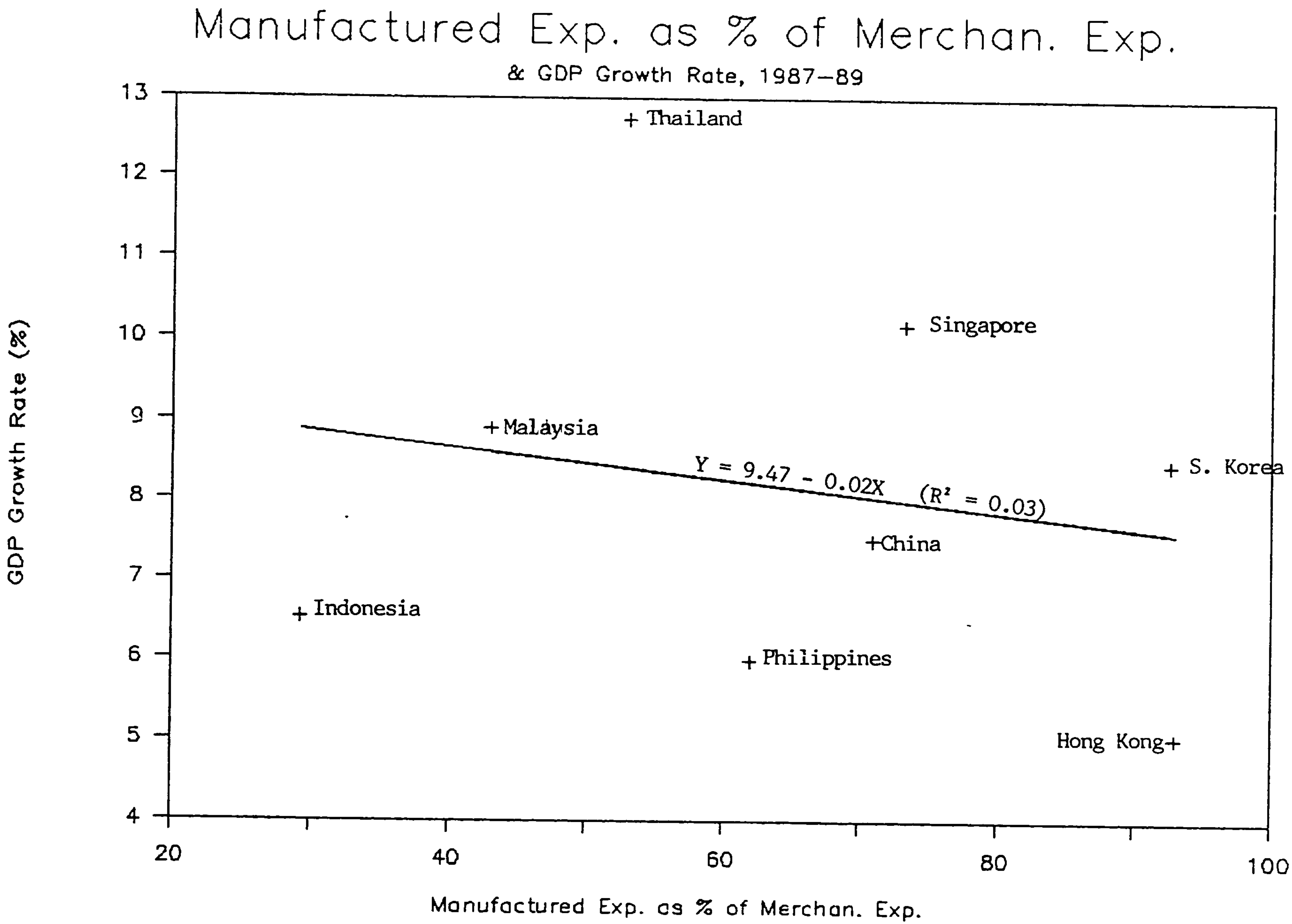
(real gdp growth rates
data of manufactured exports at current prices)

FIGURE 3



Merchandise Exports as % of GDP
& GDP Growth Rate, 1987-89
GDP Growth Rate (%)
Merchandise Exports as % of GDP
Thailand
Singapore
Malaysia
S Korea
China
Indonesia
Philippines
Hong Kong
Y = 8.03 + 0.002X (R2 = 0.002)

FIGURE 4

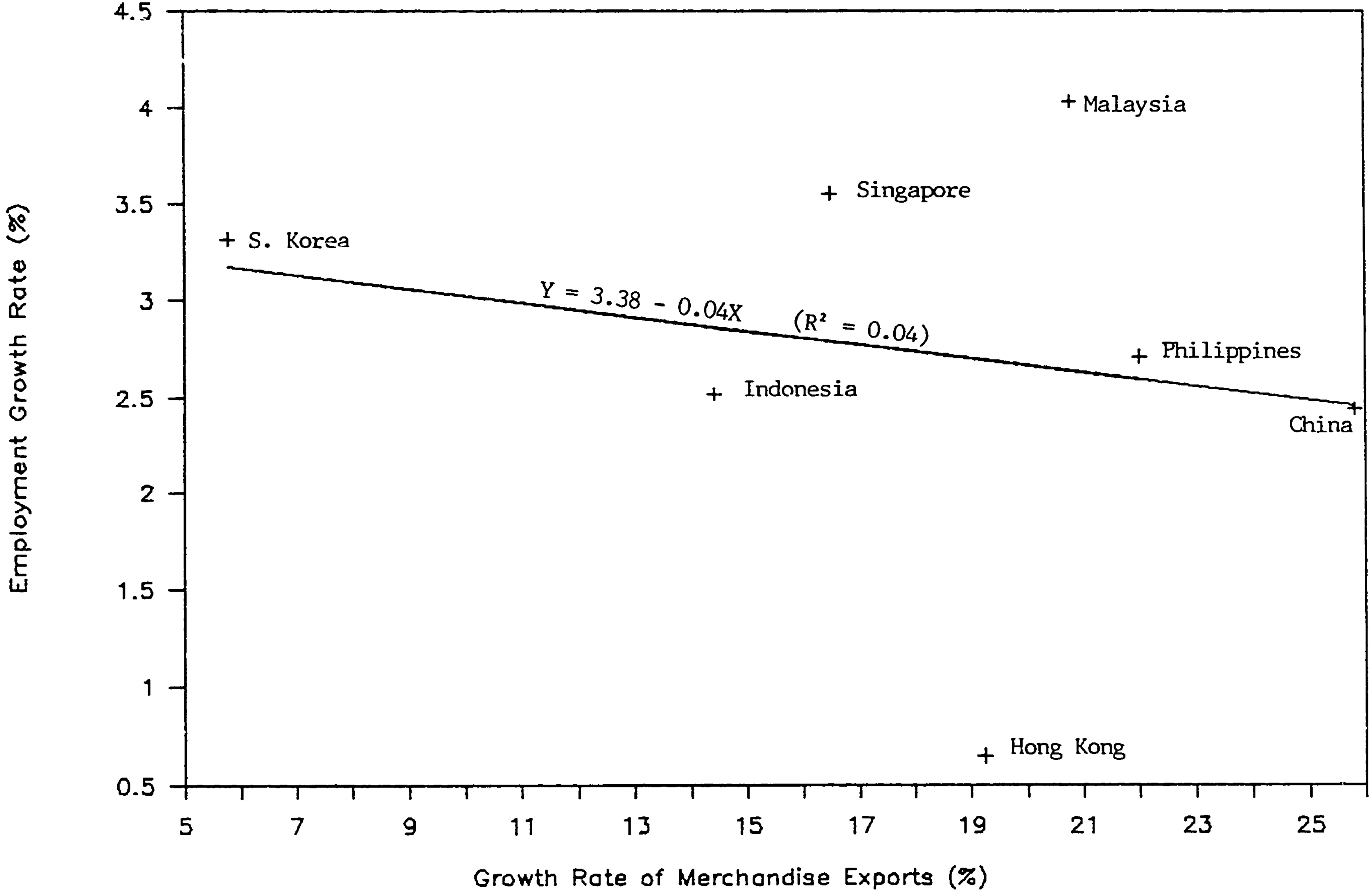


(real gdp growth rates)

FIGURE 5

Merchandise Exports & Employment

Growth Rates, 1987–90

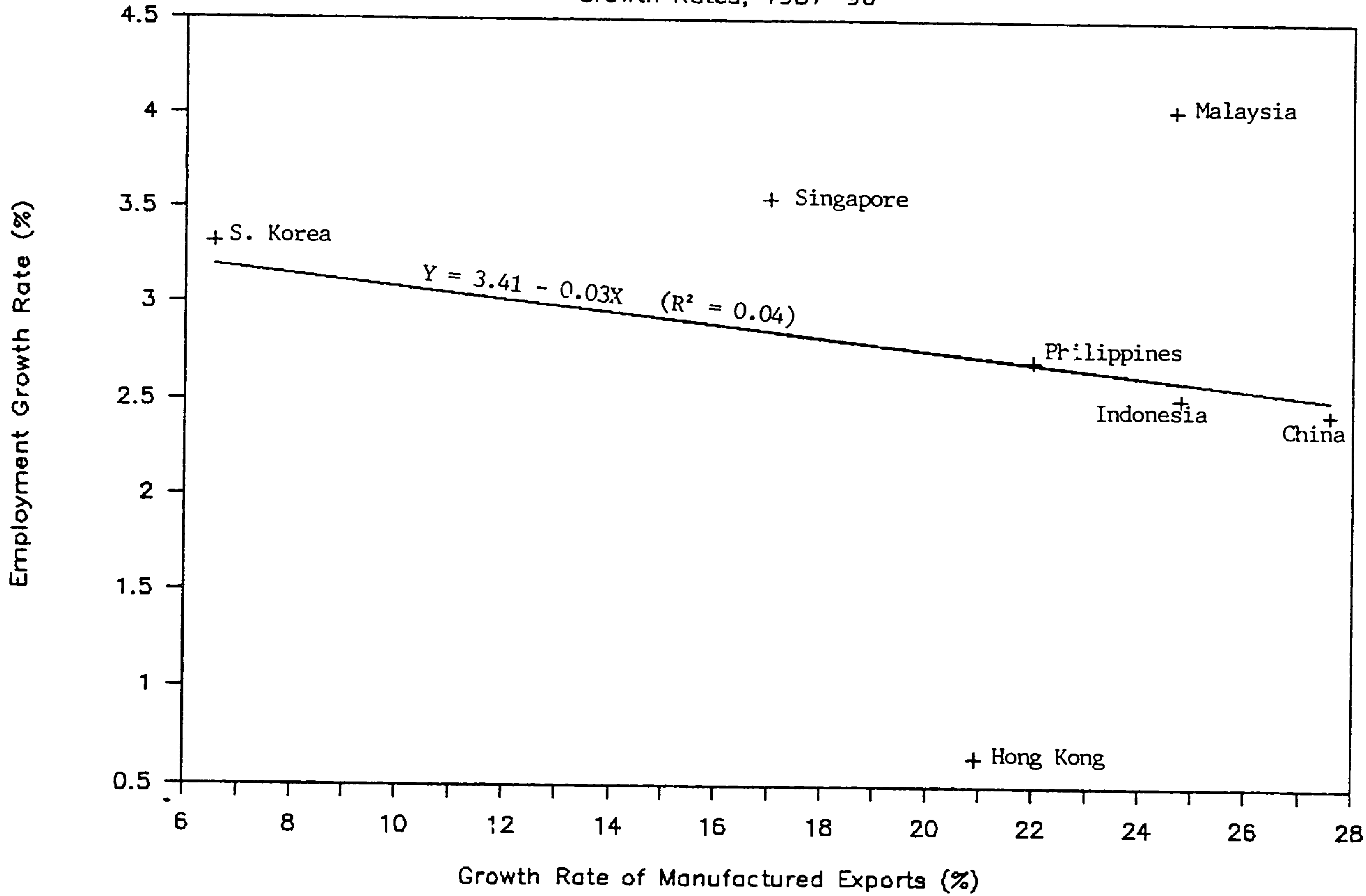


Export data at current prices

FIGURE 6

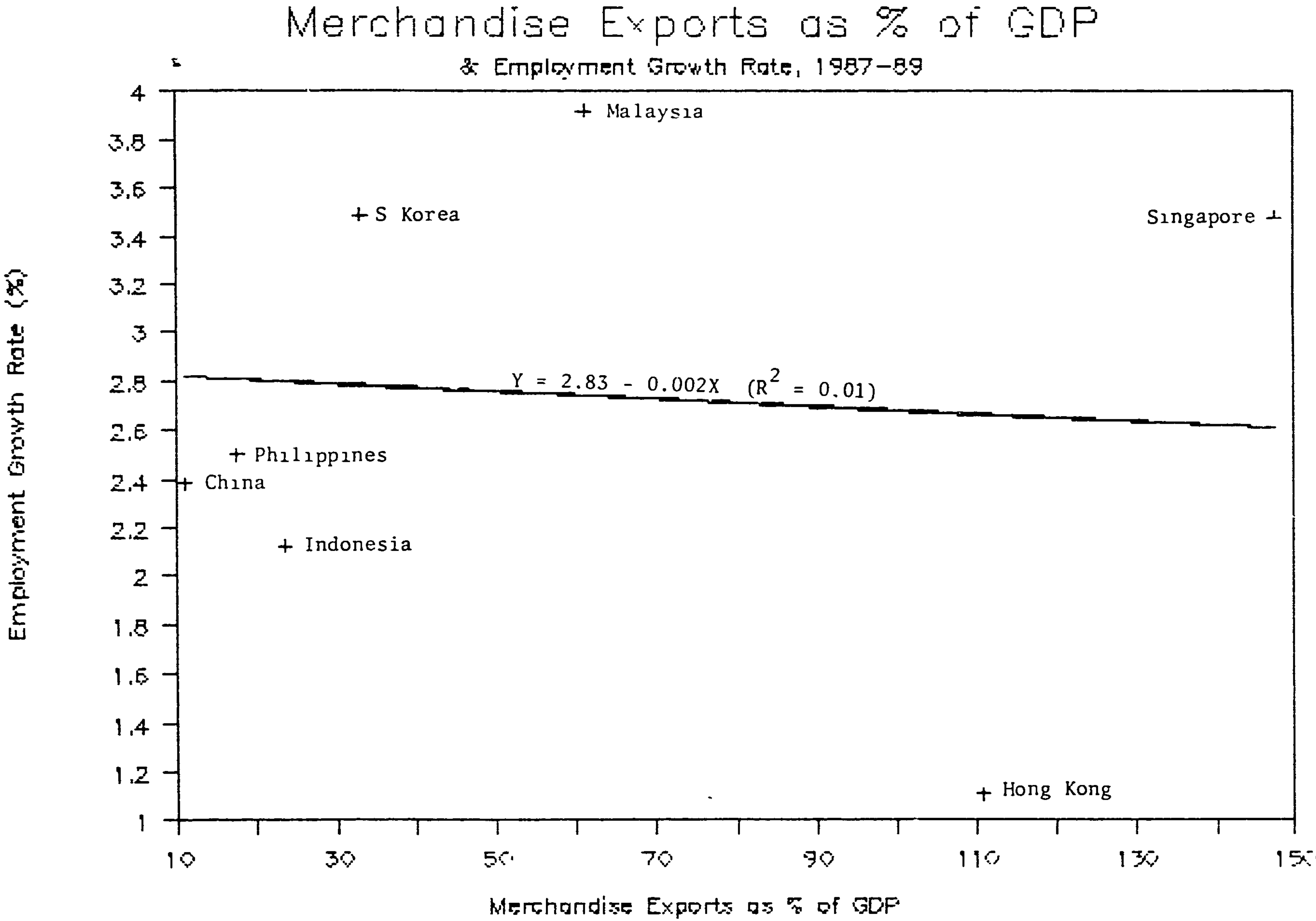
Manufactured Exports & Employment

Growth Rates, 1987–90



<u>Manufactured export</u> data at <u>current</u> prices

Figure 7



Merchandise Exports as % of GDP
& Employment Growth Rate, 1987-89
Employment Growth Rate (%)
4
3.8
3.6
3.4
3.2
3
2.8
2.6
2.4
2.2
2
1.8
1.6
1.4
1.2
1
10
30
50
70
90
110
130
150
Merchandise Exports as % of GDP
Malaysia
S Korea
Singapore
Y = 2.83 - 0.002X (R2 = 0.01)
Philippines
China
Indonesia
Hong Kong

FIGURE 8

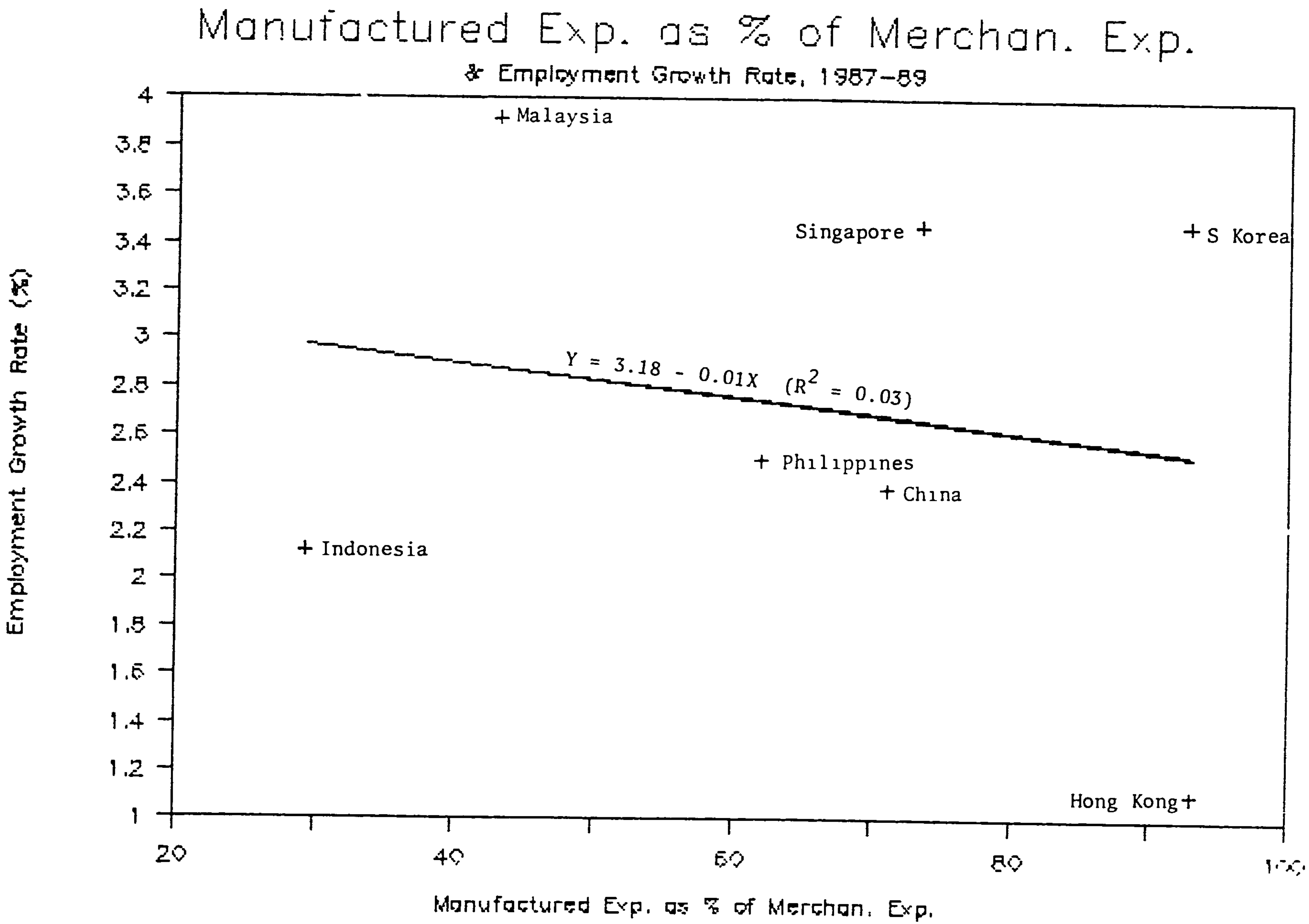
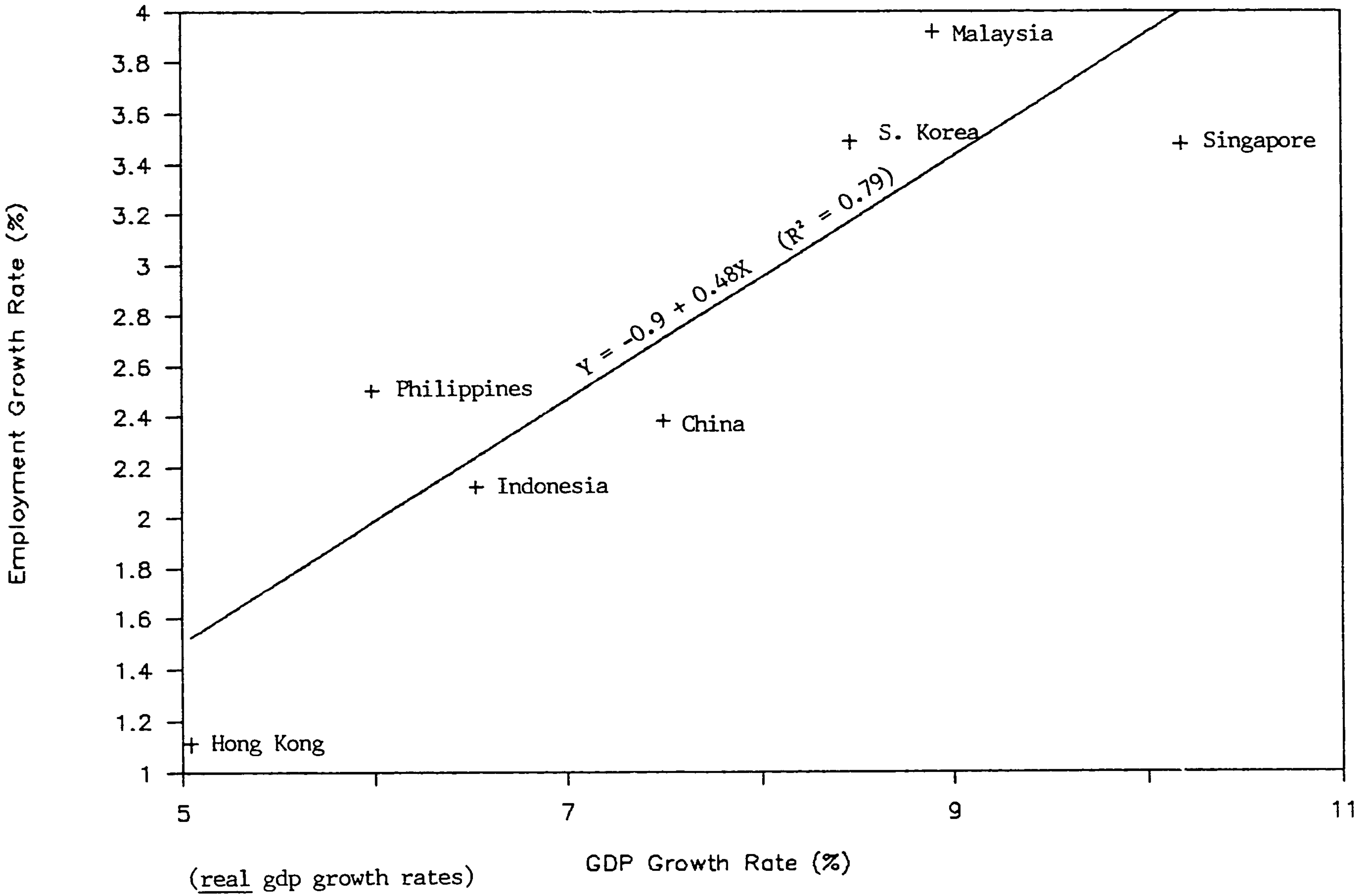

Manufactured Exp. as % of Merchan. Exp.
& Employment Growth Rate, 1987-89
Malaysia
Singapore
S Korea
Philippines
China
Indonesia
Hong Kong
Y = 3.18 - 0.01X (R^2 = 0.03)
Employment Growth Rate (%)
4
3.8
3.6
3.4
3.2
3
2.8
2.6
2.4
2.2
2
1.8
1.6
1.4
1.2
1
20
40
60
80
100
Manufactured Exp. as % of Merchan. Exp.

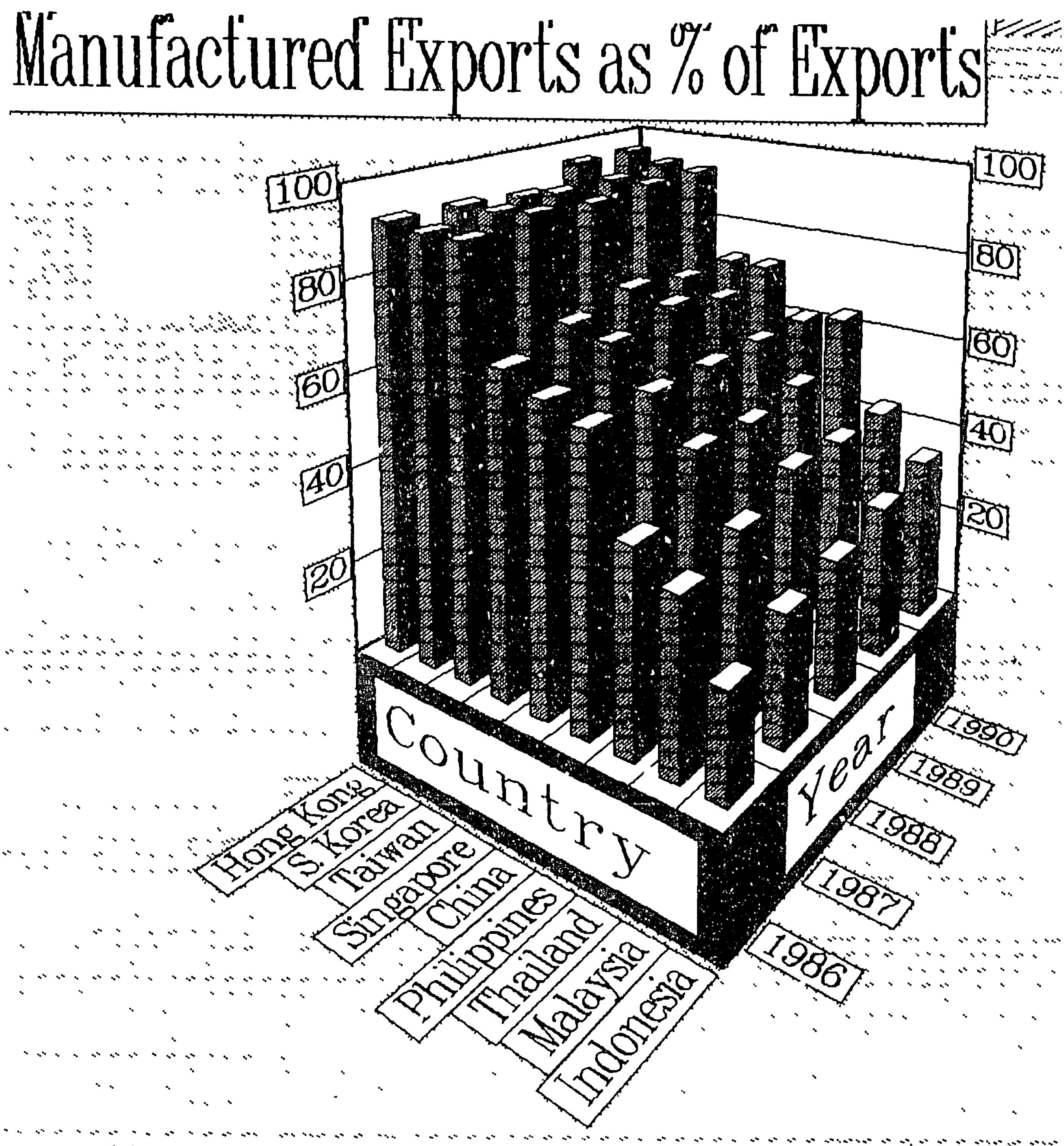
FIGURE 9

GDP Growth Rate

& Employment Growth Rate, 1987–89

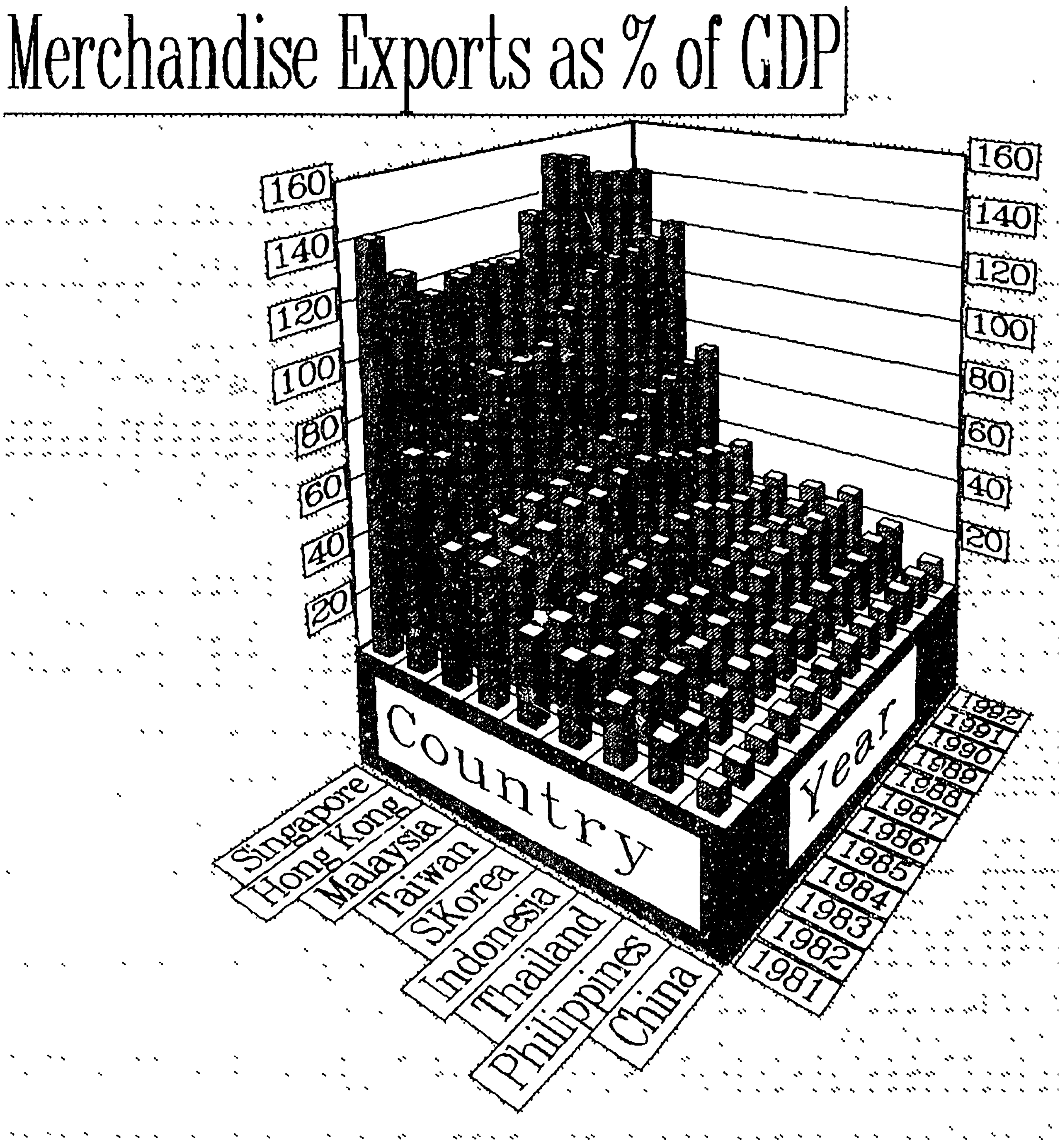


APPENDIX FIGURE 1



Source: World Bank, World Development Report, 1978-1992

APPENDIX FIGURE 2



Note 1991 and 1992 figures are projections

Source Asian Development Bank, Asian Development Outlook, 1989-91.

THE ROLE OF GOVERNMENT IN ECONOMIC DEVELOPMENT IN THE ASIA-PACIFIC REGION

Chung H. Lee*

A journey through the last century may, by destroying what Bertrand Russell once called the "dogmatism of the untravelled," help in formulating a broader and more enlightened view of the pertinent problems and in replacing the absolute notions of what is "right" and what is "wrong" by a more flexible and relativistic approach (Alexander Gerschenkron, *Economic Backwardness in Historical Perspective A Book of Essays*, pp. 26-7).

I. INTRODUCTION

What role the government may play in economic development is still very much a controversial issue. Although the collapse of the former socialist economies has proved the bankruptcy of the doctrine of the Leninist command economy there is yet no clear consensus on what role the state should play in a developing country set on the course of capitalistic development. One very telling reason for this lack of consensus if that there is now growing recognition that i some newly industrializing economies in the Asia-Pacific region governments have been an active instrument in economic development.

The role of government in economic development, especially its role in the allocation of credit and thus the allocation of investments, has not been uniform in the Asia-Pacific region. In Indonesia, for instance, the government intervened in the financial market through a banking system dominated by state-owned banks. Until recently credit ceilings and selective credit allocation were practiced by the state-owned commercial banks which were assigned specific sectors for lending activities.

Although it is designed for industrial development selective credit allocation in Indonesia favored in fact state-owned enterprises for the obvious reason that they carried the implicit government guarantee. In addition, lacking qualified personnel to evaluate competing projects, the banks were inclined to favor the

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state-owned enterprises. Thus the bulk of long-term credits to manufacturing went to two state-owned enterprises–Krakatau Steel and Permutel, a telecommunications company.

The financial system in the Philippines typifies a case where a small number of large crony firms and a weak authoritarian government joined together to protect their own economic interests. Selective credit allocation has been used by the government to support the country's traditional (agriculture, timber, and mining) exports, but bank credit went basically to heavily protected import-substitute industries. This is not surprising given that these industries are controlled by powerful family groups and they in effect control credit allocation.

In comparison with both Indonesia and the Philippines, Thailand provides, especially since 1960, a case where basically a non-dirigiste approach has been used. Most of the financial institutions in Thailand are privately owned, and their operation is seldom interfered with by Thai financial authorities for explicitly allocative purposes. When the authorities have intervened, their objectives were to support specific, short-run price-support for commodities, especially sugar, to promote the agricultural sector and later rural activities in general, and to encourage exports by extending subsidized short-term credit The primary focus of the financial authorities has been, however, on solvency and stability of Thailand's financial system, not on sectoral allocation of investment funds.

Both Korea and Taiwan--two most rapidly developing countries in the Asia-Pacific region--are different from both Indonesia and the Philippines on the one hand and Thailand on the other. In these two economies governments have been directly involved in resource allocation but nevertheless seem to have been a positive factor in economic development. What precisely the role of government has been in these two economies is, however, still very much controversial.

A widely accepted view of the economic success of Korea and Taiwan is that it is their adoption of an outward-oriented trade strategy in the early 1960s that has brought about their rapid economic development (e g., Balassa 1980, 1981, and 1988, Lau 1990). This strategy has created a stable incentive system which is neutral between exports and import substitutes and thus has led to rapid export growth. And this in turn has contributed to high rates of economic growth.

This neoclassical interpretation of the East Asian success has been challenged in a number of recent studies. An overwhelming weight of the empirical evidence is that the state has played a far more active and direct role in managing the economy (e.g., Alam 1989, Amsden 1989 and 1992, Bradford 1987 and 1992, Choi and Lee 1990, Ho 1981, Hong 1990, Johnson 1985, Lee 1992, Roh 1990, Wade 1985 and 1990, Westphal 1990, Whang 1987, Yu 1988).

According to Choi and Lee, for example, the role of the state in the Korean economy has been neither that of simply creating a favorable economic environment for private enterprises nor that of leading the economy with planning as a central policy instrument. They view the state in Korea as having played a leadership role in a close partnership with private enterprises. Likewise, according to Wade, the state in Taiwan has played an active role in promoting economic development, especially in its early stages.

In both countries the governments have utilized various policy instruments to influence the pattern of resource allocation and the pace of economic development. In Korea, the most important policy instrument has been government control over the financial system and the allocation of credit. In Taiwan, financial policy has been less important although the banking system has been owned and managed by the state. With regard to private enterprises the state has adopted an approach which is supportive and encouraging, relying mostly on policy instruments such as taxes and subsidies. But, because of the importance of the state-owned enterprises the state has had a significant allocative influence on the entire economy.

In this paper Korea and Taiwan are chosen for a detailed examination as governments in these countries seem to have made a positive contribution to economic development and may thus provide a role model for the developing countries in Africa. A careful examination of these two economies is well warranted especially now because there seems to be an over-reaction to the failure of planned socialist economies and thus a denial of any positive role for the state in economic development. In the words of Bruno, who has studied reform attempts in five East European countries (1992, p. 775):

> ...,capitalism is viewed simplistically by those who would like to embrace it as a well-oiled system consisting only of private property ownership and pure laissez-faire and self-adjusting market mechanisms, requiring no government interference However, market failures often occur in the most laissez-faire economies (for example, in financial markets), and governments have to intervene in the microeconomy
>
> Thus, a hands-off policy during the transition from a centrally planned to a market economy would be most inappropriate. The temptation to resort to the old mistakes under central planning may be strong--for example, in the process of restructuring--but that possibility should not be used as an argument against any government intervention during the transition period

There is no dispute over the fact that both Korea and Taiwan adopted an outward-oriented trade strategy early in their development process. But it is not the only policy that has been undertaken in these economies. It is our contention that most of the developing countries do not have all the institutions and professions necessary for the efficient functioning of markets and thus need to develop them. To do so is, however, a time-consuming process. In such countries the state will have to do more than what is implicit in outward-oriented trade strategies as well s in the standard neoclassical economics. Besides developing market-supporting institutions and professions the state may perform certain functions that may accelerate the pace of economic development.

In this paper we posit the hypothesis that economic development is a progression through a series of different phases of trade orientation. In this hypothesis an outward-oriented trade strategy is only one of many policies that a government may undertake to facilitate the transition from one phase to the next. There are other policies as well, which we may call structural or supply-side policies as they affect the structure of the economy. Both outward-oriented trade strategies and supply-side policies affect the structure of the economy, but the former affect it indirectly whereas the latter affect it directly. An obvious example of supply-side policies is the industrial policy that has been used in Japan and Korea and to a lesser extent in Taiwan. Even in the latter, for export expansion it was not enough just to remove trade distortions and let latent comparative advantage exert itself automatically. In addition, it was necessary to introduce institutional innovations and adaptations necessary for the effective realization of comparative advantage (Myint 1982).

Section II discusses an East Asian model of industrial development based on work by Akamatsu (1962), Ohkawa and Kohoma (1989) and Yamazawa (1990). Section III describes the transition of the Korean economy from a predominantly agricultural economy to a modern industrial economy and presents a theoretical justification for the role of the state in that process. Section IV discusses the experience of Taiwan in transforming its economy, the role of the state in that process. Section V concludes with some possible lessons for the developing countries in Africa.

II. AN EAST ASIAN MODEL OF INDUSTRIAL DEVELOPMENT

Korea and Taiwan have shared certain common initial conditions that were conducive to economic development. Both carried out successful land reforms; both experienced Japanese colonial occupation which had established basic educational and physical infrastructure; both have a labor force which is imbued with a work ethic and which values education; both are poor in natural resources; and both have received generous U.S. economic aid. In addition, Korea and Taiwan have had the advantage of having Japan as a source of capital and technology as well as a role model to follow.

One common characteristic that both Korea and Taiwan have shared during the period of rapid industrialization is a high investment ratio. In Korea, gross domestic investment grew at an average annual rate of 22 percent in 1961-70 and 11 percent in 1971-80 and its share of GDP was 17.5 percent during the first period and 26.4 during the second period. In Taiwan, the corresponding figures were 15 percent in 1061-70 and 12.6 percent in 1971-80 and 16.6 percent during the first period and 26 percent during the second period, respectively (Bradford, Jr 1992). These figures are higher than those for many other developing countries, which are in part attributable to government policies that deliberately underpriced investment goods and made them relatively cheaper than consumption goods in the domestic price structure (Bradford, Jr. 1987 and 1992). It should also be added that both Korea and Taiwan have made large and efficient investments in human capital and well-developed capacities to absorb new technology (Kuznets 1988).

The promotion of investment has been often carried out selectively in both Korea and Taiwan primarily with the aim of altering the industrial structure in anticipation of changes in demand and comparative advantage. To promote investment the governments have provided information to private entrepreneurs and socialized their business risk in selected areas. In the case of Korea, the government was even directly involved in creating new industries with preferential credit and the licensing of foreign capital and technology flows. As they matured into internationally competitive industries they were provided with basically neutral incentives and preferential incentives were transferred to a new group of industries (Pack and Westphal 1986). In this way the economies have been guided throı ɔh successive phases of industrial development.

1. Five Phases of Industrial Development

Japan's industrial development is described by Ohkawa and Kohama (1989) as a progression through different phases of trade orientation and technological complexity. More specifically, in the course of its economic development Japan has gone through the following five stylized phases of trade orientation and corresponding changes in the economic structure:

Phase I: a period during which traditional, agriculture-based products are exported and manufactured nondurable consumer goods are imported.

Phase II: a period of primary import substitution during which the domestic production of nondurable consumer goods takes place.

Phase III: a period of primary export substitution during which nondurable consumer goods replace traditional, agriculture-based products as exports.

Phase IV: a period of secondary import substitution during which import substitution of durable producer and consumer goods takes place.

Phase V: a period of secondary export substitution during which durable goods replace nondurable goods as exports. A country becomes fully developed when it reaches the end of this phase.

These five phases are schematically demonstrated in Figure 1 where the vertical axis measures the ratio of domestic production to total domestic demand (domestic production plus net import). When the ratio exceeds 0.5 (i.e., when domestic production exceeds the net import of the commodity), the phase of import substitution begins. When the ratio exceeds one (i.e., when the country is a net exporter of the commodity), the phase of export substitution begins. The three curved lines indicate that the country first starts as a net exporter of primary products while importing light manufactured goods. At t_1 the country enters the phase of primary import substitution, producing light manufactured goods at home and then becomes a net exporter of these products at t_2. At t_3 it begins secondary import substitution producing durable producer- and consumer-goods at home, and at t_4 the country enters the phase of secondary export substitution, export these products.

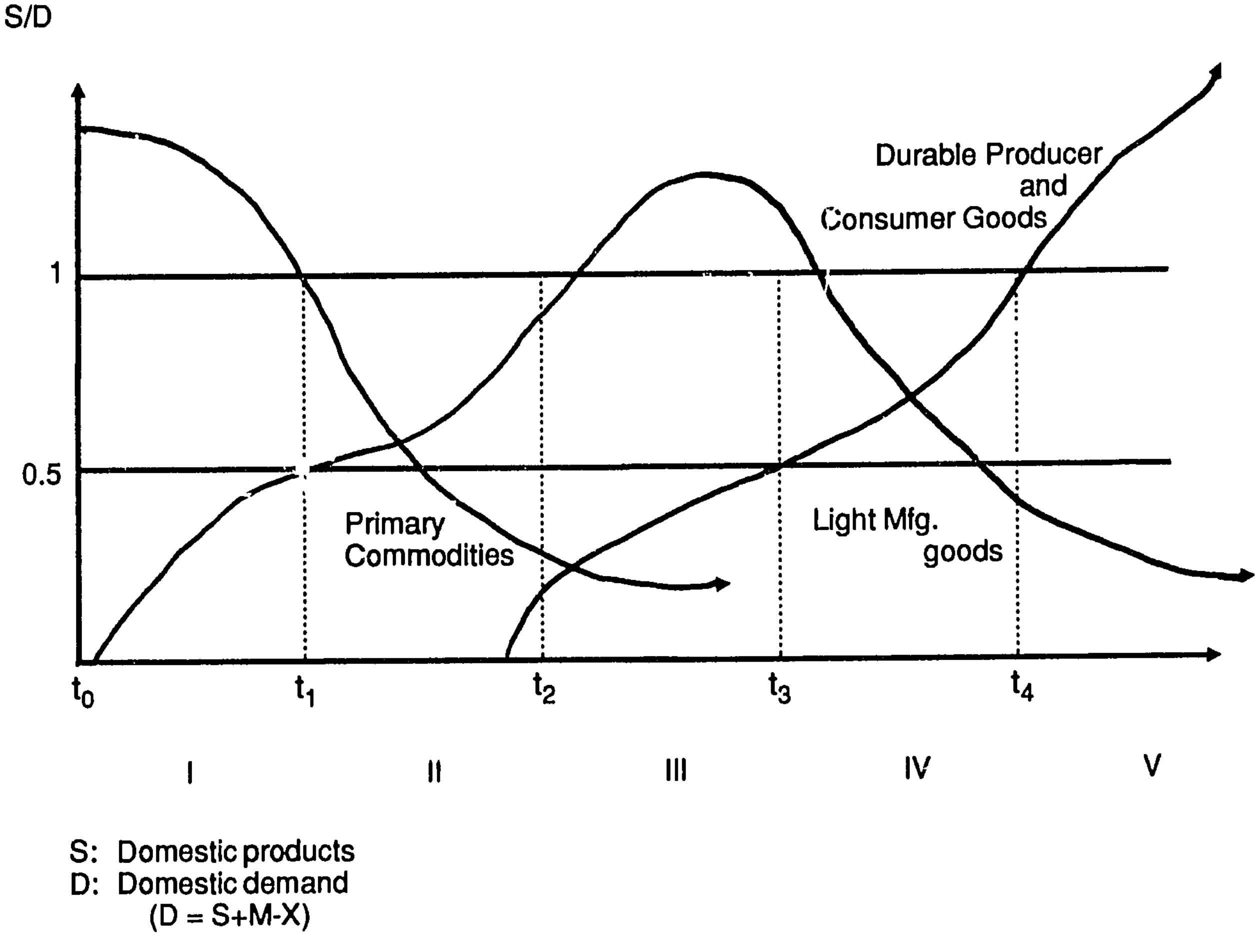

FIGURE 1

According to Ohkawa and Kohama, Japan went through the first and second phases in 1870-1900, the third phase in 1900-19, the fourth phase in 1920-60, and the fifth phase in 1969-75.

The basic determinant of Japan's transition from one phase to the next was the level of technology that had been achieved by its domestic producers relative to that abroad. A product was first introduced from the West when Japan was technologically incapable of producing it at home. Its import substitution then began with the transfer of technology, and when the domestic technology "caught up" with the Western technology its export began. Finally, when other developing countries caught up with the Japanese technology the product ceased to be exported and the reverse import began (Yamazawa 1990). In Japan, this process has repeated for a series of products in the ascending order of technological complexity Thus Japan's industrial development began with light manufactured goods such as textiles and moved to technologically more sophisticated products such as steel and automobiles and then finally to high-tech electronics.[1]

[1] Ohkawa and Kohama (1989, p 275) note that in the case of post-war Japan the competitive private sector and the technology accumulated during World War II facilitated the rapid transition from Phase IV to Phase V. During the war the country's technological knowledge and human capability improved greatly over a wide range of industries due to the rapid pace of industrialization forced upon by military mobilization Thus the share of manufacturing and mining net output in NDP was as high as 39 7 percent in 1940, and this forced industrialization and technological advancement had a significant technological "spillover" effect in the subsequent peacetime years

Economic development as a progression through these phases has also taken place in Korea and Taiwan. According to Ohkawa and Kohama, Korea when through the second phase in 1953-1964 and the third phase in 1964-1972 and entered the fourth phase in 1973, which may have ended in 1985. Both Korea and Taiwan entered the fifth phase in the mid-1980s.[2]

In the standard neoclassical theory, an economy would automatically make the transition from one phase to the next as its comparative advantage changes. Comparative advantage in turn would change as the country's factor endowments and technologies change. Thus a labor-surplus economy with a relatively large traditional agricultural sector would start its industrialization first with labor-intensive, technologically simple manufacturing industries. As the economy develops and passes the Lewisian turning point, its capital stock will increase relative to its labor force and its comparative advantage will shift from labor-intensive to capital-intensive industries. Also with increases in its human capital stock the country will gain a comparative advantage in technology-intensive industries. Given these determinants of comparative advantage, the speed at which a country goes through the five phases of industrial development will depend on the rate of capital accumulation, the rate of population growth, and the rate of technological advancement relative to those in the rest of the world Furthermore, it will be an optimal speed if changes in comparative advantage take place in a competitive, free-trade economy without any interference by the government. This is in fact the path commonly described as the early industrialization process that took place in England (Gerschenkron 1962).[3]

The East Asian countries of Japan, Korea, and Taiwan did not follow this neoclassical precedent or prescription but took an alternative approach to industrial development.[4] In these countries the state has intervened actively and directly with markets in order to accelerate the speed of industrial development although the degree and intensity of state intervention has varied from country to country and over time even within a country In other words, their comparative advantage was not a variable determined solely by relative factor endowments and market-determined rates of technological change but a variable deliberately influenced by the state. As Li and Yeh (1981, p. 112) put it, in the case of Taiwan changes in comparative advantage and industrial development were "an orderly progression from labor-intensive light industries to

[2]Fei, *et al* (1985) attributes this "telescoping" of Phase III in Korea and Taiwan, relative to the duration of the same phase in Japan, to (1) the faster growth of agricultural productivity and of industrial technological opportunities which more than offset the faster growth of population in Korea and Taiwan, (2) the rapid expansion of world income and trade during the 1960s, and (3) the ample supply of foreign capital and foreign aid during the second half of the 20th century

[3]Gerschenkron (1962, p 14) presents the following description of England's early industrialization "The industrialization of England had proceeded without any substantial utilization of banking for long-term investment purposes The more gradual character of the industrialization process and the more considerable accumulation of capital, first from earnings in trade and modernized agriculture and later from industry itself, obviated the pressure for developing any special institutional devices for provision of long-term capital to industry

[4]The developmentally active state in the East Asian countries is characterized by Chalmers Johnson (1985) as a "capitalist development state" in contrast with a "capitalist regulatory state" in the Anglo-American countries. However, Yamazawa (1990) argues that the oft-cited "Japan Incorporated" does not give an accurate picture of the role of the state in the Japanese economy He admits, nonetheless, that there has been closer cooperation between the government and private business in Japan than in the United States and this cooperation has contributed to Japan's industrial development.

Germany and France, latecomers relative to England in industrial development, also took a path different from the neoclassical path of industrial development. The speed and character of their industrial development were influenced by the application of "institutional instruments for which there was little or no counterpart in an established industrial country" (Gerschenkron 1962, p.7) capital- and technology-intensive industries" helped by the "government's strategy of promoting rational, stage-by-stage development."

Relative factor endowments have not been, however, neglected in creating a comparative advantage in these countries. Lacking natural resources they have never tried to create a comparative advantage in resource-rich industries. Instead, they initially developed their comparative advantage in industries which are relatively intensive in unskilled labor and then moved into industries of greater technological complexity as both human and nonhuman capital accumulated. The point is that in these countries this transition has not been a *solely* market-determined process but has been aided by the state which has done more than providing a stable and neutral incentive system in order to accelerate the pace of industrial development. What the state actually has done is the topic of sections III and IV of this paper.

2. Trade Policies in the East Asian Development Model

Once economic development in East Asia is seen as a progression through the five phases of industrial development and the primary import-substitution as its beginning, the adoption in Korea and Taiwan of an outward-oriented development strategy in the early 1960s should be looked at more as a shift in trade orientation necessary for the transition from one phase to the next in the process of industrial development than as a radical change in economic philosophy. In other words, it should be regarded as a timely change in trade orientation at a particular juncture in industrial development. Import-substitution policy for nondurable consumer goods industries in Phase II is not then a distortionary policy which kept the economy from exploiting its comparative advantage and growing rapidly. It instead prepared and readied the economy of the phase of primary export substitution, which with the help of export-promotion policy expanded rapidly in the 1960s.[5]

It can be also seen that for an economy progressing through these phases import-substitution and export-promotion policies are not necessarily mutually exclusive alternatives. Both policies may be carried out simultaneously but being respectively applied to different industries. Thus during the phase of primary import substitution export-promotion policy may be in place for traditional products while import-substitution is carried out for light manufacturing industries. Likewise, during the phase of secondary import substitution export-promotion policy may be carried out for light manufacturing industries while import-substitution is carried out in durable goods industries.

In an economy in which both export-promotion and import-substitution policies are carried out, the former may very well offset the distortionary effect of the latter and thus the resulting incentive structures

[5]By concentrating on the performance of the Korean economy for periods beginning in the early 1960s and on the policies taken since then many researchers of the Korean economy tend to disregard the changes that had taken place in the economy during the 1950s and the policies taken to bring about those changes. This tends to lead to the conclusion that the non-discriminatory export-promotion policy of the 1960s worked better than the policy of the 1970s which was more selective in promoting industries. See, for example, Yoo (1988). The same may be said for Taiwan.

may be unbiased and neutral. In other words, the effective exchange rate for imports--the number of units of domestic currency that would be paid for a dollar's worth of imports, taking into account tariffs, surcharges, interest on advance deposits, and other measures that affect import prices--may be equal to the effective exchange rate for exports--the number of units of domestic currency that can be obtained for a dollar's worth of exports, taking into account export duties, subsidies, special exchange rates, input subsidies related to exports, and other financial and tax measures that affect export prices. And it has been argued that the resulting neutral incentive system has brought about allocative efficiency and thus rapid economic growth in Korea and Taiwan (Bhagwati 1978, Westphal 1978).

This argument--that mutually offsetting import-substitution and export-promotion policies brought about allocative efficiency and thus economic growth--neglects an important dynamic effect of import-substitution policy. One could argue that in both Korea and Taiwan this policy had led to the establishment of new export industries for the subsequent phase of industrial development while maintaining allocative efficiency in the current phase. In other words, a trade regime with both export-promotion and import-substitution policies may in fact turn out to be the same as a free-trade regime in terms of its dynamic effect on industrial development.[6]

Another point to be made about the argument that mutually offsetting trade policies has brought about neutral incentive structures in Korea and Taiwan is that neutrality between exports and import substitutes does not necessarily imply the neutrality of incentives for the entire economy. In any economy consisting of tradeables and nontradeables sectors the effect of an equi-proportional increase in both the supply price of exportables and the supply price of importables is to bring about a real depreciation--an increase in the price of tradeables relative to that of nontradeables. In other words, mutually offsetting export-promotion and import-substitution policies would bring about a change in incentive structures biased in favor of both exports and import substitutes at the expense of nontradeables.

Given that both Korea and Taiwan began their industrialization with a dual-economic structure consisting of a relatively small industrial base, the incentive system brought about by mutually offsetting trade policies was in fact an incentive system biased in favor of industrialization. Thus the outward-oriented trade policy in Korea and Taiwan, even if it had the effect of bringing about neutral incentives between exports and import substitutes, was in fact a policy promoting industrial development.[7]

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[6]In his study on the performance of eleven successful developing countries for 1965-83, Hirata (1988) finds that all but with the possible exception of Hong Kong and Singapore used both import substitution and export promotion policies simultaneously The key to their success seems to be, according to his study, a balance between the promotion of domestic industries and the promotion of exports

[7]According to the estimates of Korea's real effective exchange rates carried out by Nam (1981), the ratio of the real effective exchange rate for exports to that for imports was 0 96 in 1966, changing to 0 99, 1 02, 1.03, 1 02, 1 09, 1 04, 0 98, 0 96, 0 97, 0 96, 0 94, 0 88 for the successive years till 1978 Nam notes that since non-tariff restrictions of varying intensities played an important role in protecting Korea's import-substitute industries these measures are likely to be an overestimate of the true ratio.

III. INDUSTRIAL DEVELOPMENT IN KOREA

1. Policies for Industrial Transition

Industrial development in Korea has not been a process determined solely by the private sector operating under a stable and unbiased incentive system. It has been strongly influenced by government policies designed to help the economy move through the successive phases of industrial development.

1-a. From Primary Import Substitution (1953-64) to Primary Export Substitution (1964-72)

When the Korean peninsular was divided into two parts in 1945 South Korea was a predominantly agricultural economy with no major industry to speak of. There were some light manufacturing industries established during the Japanese colonial period, but even these were destroyed during the Korean War of 1950-53.

The post-war reconstruction of the Korean economy was basically that of establishing or re-establishing nondurable consumer goods industries. Trade policy was inward-looking as imports were controlled with both high tariffs, various quantitative restrictions, a complex system of multiple exchange rates, and an overvalued exchange rate. Under all these protective measures the consumer goods industries achieved healthy growth, but by the early 1960s their growth faltered as it reached the limits of the domestic markets. Thus, having completed postwar reconstruction and reached the end of the primary import substitution phase by the early 1960s Korea was in a position to begin exporting its light manufactured products.

A switch in trade policy occurred in 1961-63 when the government introduced several measures to promote exports.[8] Direct subsidies were given to certain export commodities while preferential loans were provided for all exports. Tariff exemption on imports of raw materials used for manufacturing export products and the exemption of indirect taxes on exports and intermediate inputs used in export production were introduced. A 50 percent reduction in income tax was also granted on earnings from exports and tourism (Kwang Suk Kim 1991).

After a major devaluation in 1964 the government introduced additional export-promotion measures. These included accelerated depreciation allowances for export industries and wastage allowances on raw materials imported for the manufacture of exports. Because there were neither tariffs nor indirect taxes on imported raw materials these allowances were a source of large profits to those engaged in export production as they could be used of domestic production or sold on the market.

[8]For an interesting discussion of the politics of the transition from import substitution to export promotion policy see Haggard, Kim and Moon (1990)

In addition to these financial incentives the Korean government utilized direct, administrative measures to promote exports. For example, it created the Korea Trade Promotion Corporation (KOTRA), which with its extensive overseas network became an effective instrument for promoting exports.

What was perhaps unique to Korea was the Monthly Export Promotion Conference which was established in December 1962 and came to be one of the most important administrative support mechanisms for exports. The meeting was attended by President Park Chung Hee, the Minister of the Economic Planning Board, the Minister of Trade and Industry, the Director of the Korea Trade Promotion Corporation, the Chairman of the Korea Traders Association and other public officials and private experts concerned with trade. The progress of exports and the performance of exporting firms were routinely reported at the meeting, and almost every month the President made the practice of awarding successful businessmen with medals and citations.

At the conference, businessmen were asked to present their problems and opportunities, and government officials were informed in front of the president of the problems that businessmen had faced in dealing with government offices. The conference thus served not only as a forum in which the president could hector businessmen to increase exports but also as a place where they could frankly discuss with the president various problems, including bureaucratic redtapes, that they had run into in attempting to achieve their export targets.

Another administrative measure used for export promotion was the export-targeting system adopted in early 1962. It was initially used to establish an annual target for total exports, but by the second half of the 1960s the system became more elaborate with annual targets set for major commodity groups and destinations. Targets for major commodity groups were then assigned to related industrial associations and targets for destinations were given to the Korean embassies in respective countries or regions for implementation. A "situation room" was installed inside the Ministry of Commerce and Industry to monitor export performance, comparing it with the annual targets. The status of export performance was then reported at the Monthly Export Promotion Conference, which the president regularly attended.

An important aspect of the export promotion policy in the 1960s is that most of the promotion measures were basically non-discriminatory. For instance, preferential credit was given to any exporter, whichever product he might export, as long as the exporter could present an export letter of credit at a foreign exchange bank.

This non-discriminatory export promotion policy is often cited as an indication that the government maintained incentive structures favorable to exports as a whole but neutral as to the composition of exports in the 1960s (Kim and Leipziger 1992, World Bank 1986). The fact is that Korea then had a very small manufacturing base--mostly light nondurable consumer goods--and consequently there was very little to be selective about in promoting exports. Furthermore, the economy was not ready for the next phase of export promotion, i.e., the phase of secondary export substitution.

1-b. Secondary Import Substitution (1973-83)

The secondary import-substitution phase in Korea began formally in June of 1973 with the promulgation of the Heavy and Chemical Industries (HCI) Promotion Plan. According to the plan, six industries--steel, nonferrous metal, machinery (including automobiles), shipbuilding, electronics, and chemicals--were to be promoted at the total investment amounting to US$9.6 billion between 1973 and 1981. These were targeted to become future leading industries which would account for more than 50 percent of Korea's total commodity exports by 1980.[9]

In the early 1970s there were virtually no Korean firms that possessed the technical as well as financial resources necessary for undertaking any one of the heavy and chemical industries. Furthermore, given large scale-economies and high risks inherent to such industries not many firms, including the large business groups called *Chaebol*, were willing to undertake the projects Thus to implement its plan the government had to handpick suitable firms and in fact coerced them into undertaking the projects with the offers of various incentives.

The HCI program is a clear case of a close co-operation between the state and the private sector in preparing the economy for changing international conditions and comparative advantage. By the late 1960s Korea began to face import restrictions on its light manufactured exports in the United States and other developed countries. It also began to face a challenge from China and the developing countries in Southeast Asia in the world markets for light manufactured goods. These changes prompted the government to promote the heavy and chemical industries for the next phase of industrialization.

The selection of these industries for industrial promotion came as a matter of course to the top policy makers as they were fully aware of the fact that Japan had earlier taken the same path of industrial development with great success Furthermore, the experience in helping the light manufacturing industries to become internationally competitive gave them confidence in Korea's ability to establish the heavy and chemical industries as a next candidate for export industries.

An additional factor, no less important than these economic factors, was a major change in the foreign policy of the United States toward Asia. In July 1969 the Nixon Doctrine was announced, signalling the withdrawal of direct U.S. involvement in Asia. Subsequently, in the spring of 1970 it was decided to withdraw U.S. troops from Korea, and march 1971 saw the completion of the first phase of troop withdrawal. In the face of this development, which clearly had serious implications for national security, President Park Chung

[9]For a more comprehensive discussion of the Heavy and Chemical Industries Promotion Plan, see Suk-Chae Lee (1991)

Hee decided to establish Korea's own defense industries, which in turn required the establishment of the heavy and chemical industries. Accordingly, various measures were introduced to carry out the HCI program.

In order to provide a market for the new industries, the government re-instituted import restrictions and rolled back tax exemptions on the import of certain intermediate goods and capital equipment. It also granted higher investment tax credits to businesses which purchased domestically produced machines.

A major package of tax incentives for investment in the heavy and chemical industries was provided in the Tax Exemption and Reduction Law of 1975. It included tax holidays, investment tax credits, and accelerated depreciation for the firms investing in the designated industries. These tax incentives had the effect of lowering the tax rate on the marginal return to capital by 10 to 15 percentage points, making the tax rate about a quarter lower than otherwise (Kwack 1984).

The government began also investing heavily in the infrastructure relating to the heavy and chemical industries: large-scale industrial parks were constructed; educational and training systems were overhauled to produce engineers and skilled workers; and research institutes were established to develop necessary technology.

Separate industrial complexes were established throughout the country: Pohang for steel, Kunsan for nonferrous metal, Kumi for electronics, Changwon of machinery, Ulsan, Ok-po, and Chukdo for shipbuilding, and Ulsan and Yeochon for chemicals.

The educational system was revised to increase the supply of skilled manpower. Thus between 1973 and 1980 the enrollment capacity of science and engineering colleges expanded from 26,000 to 58,000 and the total enrollment in technical high schools doubled and that in technical junior colleges increased more than fivefold.

Six research institutes were established for science and technology, especially for the machinery, chemistry, and electronics sectors, with the corresponding increase in research and development expenditures financed by government.

What was perhaps most important among all these measures taken by the Korean government to implement the HCI plan was its use of financial policy. The government was directly involved in mobilizing and allocating financial resources for the targeted industries. It did so by controlling much of the credit system and given preferential credit to these industries.

To finance the new projects the government established the National Investment Fund, a special fund contributed by the government and financial institutions. The funds thus raised were not, however, sufficient for the entire HCI program, and as an additional measure the government required a portion of commercial bank loans to be allocated to the heavy and chemical industry projects.

Because of the policy of preferential credit the firms engaged in the HCI program received loans with a longer period for repayment and at a rate of 25 percent lower than that for other industries. This difference in borrowing costs, however, disappeared during the HCI adjustment period of 1979-81.

An effect of all these promotion measures was the creation of excess capacities in the heavy and chemical industries by 1979. The severe world recession following the second oil shock, combined with a tight monetary policy at home, worsened the problem, requiring subsequent restructuring of the industries by the government. It can be said, however, that it was this excess capacity in human as well as nonhuman capital that laid a foundation for the export boom in the heavy and chemical industries that began in 1983.

1-c. Secondary Export Substitution (1984-)

The double-digit economic growth in the middle of the 1980s was led by the exports of and investments in the heavy and chemical industries coincided with the beginning of the secondary export substitution phase. The successful establishment of the heavy and chemical industries now allowed the substitution of domestic supply for hitherto imported industrial intermediate inputs. Thus the users of petrochemical products could now rely on the domestic producers for a stable supply of intermediate inputs even in the midst of worldwide shortage and thus continue to expand their exports Likewise the steel industry played a key role in sustaining the competitiveness of Korea's manufactured exports by serving domestic industrial activities even during a worldwide shortage in steel.

An important change in the role of government took place during this phase of industrial development. State intervention has become less direct but more functional, and its position vis-a-vis private enterprises has become relatively weaker. The development of the Korean semi-conductor industry is illustrative of this change.

In the development of the semi-conductor industry the government has played an important role. For example, it established the Korea Institute of Electronics Technology, the Electronic Technology Research Institute and the Korea Advanced Institute of Science and Technology to bring about technological advances in the electronics industry. But since 1986, when the government began seriously promoting the high-tech industries, its relationship with private firms has been that of more or less equal partners. One of the reasons for this changed relationship is the recognition that some of the Korean firms such as Samsung, Hyundai, and Goldstar are large enough to possess excellent organizational and R&D capabilities and are thus able to undertake semi-conductor projects without substantial support from the government (Hong 1992).[10]

[10]According to Hong (1992) the Korean government was under strong pressure from the United States because of the aggressive export of the Korean semi-conductor industry. It was pressured not to engage in any state subsidies for the industry, and since the middle of the 1980s this pressure has been a major source of constraint on the government's promotion policy toward the semi-conductor industry

2. The State and Finance in Industrial Development

One of the most important and powerful policy instruments that the government has used for industrial development in Korea, especially during the phase of secondary import substitution, is financial policy. With the financial system practically under its direct control the government used the financial system to mobilize and allocate financial resources and thus to bring about industrial development

Immediately after the military coup of 1961 the commercial banks were nationalized through the confiscation of wealth allegedly accumulated illicitly during the previous regime. The annual budgets of the commercial banks and appointments to top management then become subject to the approval of the finance minister. Special banks such as the Korea Development Bank and the Small and Medium Industry Bank were also established but they were fully government-owned and -controlled.

Under government direction the commercial banks channeled an increasing amount of bank loans to the manufacturing sector for the explicit purpose of promoting exports. Then, in the 1970s when the government began its push for heavy and chemical industries the allocation of credit became more selective. The share of bank loans allocated to these industries increased from less than 20 percent in 1970-74 to over 29 percent by 1980. A majority of foreign loans was also channeled to these industries (Park 1991, pp. 59-60).

A financial system such as the one that has existed in Korea has been a topic of much research ever since the contribution by McKinnon (1973) and Shaw (1973) to the literature on finance and development. In such a system the government maintains artificially low interest rates, and it is now widely accepted that this interference results in a resource misallocation and thus economic stagnation.

What is therefore puzzling in the light of the Korean experience is how the country has been able to achieve successful industrialization with such a financial system. An answer to the puzzle lies in a fundamental shift in the way we look at the relationship between the state and the market.

2-a. Need for a New Theoretical Framework

Recent developments in the theoretical literature on finance point out that financial markets do not operate in the manner of "textbook models" and instead "credit-rationing" and "equity-rationing" are inherent characteristics of these markets (Stiglitz 1989).

Credit rationing by banks occurs because banks have less information about the credit-worthiness of prospective borrowers than the borrowers themselves and because banks are risk averse (Stiglitz and Weiss 1981). Thus even without government intervention banks would set interest rates below market-clearing rate and ration credit among prospective borrowers. Such credit rationing can lead to an inefficient allocation of credit especially in the absence of well-functioning equity markets (Cho 1986). But even where there is an equity market, equity rationing takes place because of problems of adverse selection. In the absence of perfect information, equity markets may be unable to differentiate between good and bad issues, and thus may unduly discount share prices. Unwilling to see its net worth decrease, "good" firms will be reluctant to issue new shares and will rely more on internal financing for capacity expansion. This can result in an inefficient allocation of resources.

Though these problems are inherent in all financial markets, there are reasons why they are particularly serous for developing countries. Capital markets are generally less developed and the economy is subject to greater uncertainty, particularly where the political system is unstable. The problems of weak social infrastructure for communications, transportation and contract enforcement are well-known (Diaz-Alejandro 1985). Finally, the small scale of business enterprises in most of the developing countries implies a lack of capability for collecting, evaluating, and disseminating information, and the absence of internal capital markets capable of allocating funds among diverse subunits [11]

The existence of credit and equity rationing does not justify government intervention, since private institutions such as internal capital markets develop to cope with imperfect financial markets. Moreover, even with imperfect markets, free financial markets may still be superior to government intervention. So the critical issue centers on the conditions under which various policy regimes are likely to yield the better results.

The "financial system" is usually taken to mean the collection of financial markets in a given economy, be they formal credit markets, stock markets, or curb markets. We need to recognize that the mobilization and allocation of financial resources, even in highly developed countries, are not limited to these market institutions. Non-financial institutions, be they households or manufacturing firms, also carry out the mobilization and allocation of financial resources. These internal capital markets are not necessarily primitive institutions preceding the development of a market, but rather an institutional development that has evolved in response to market imperfections. Since the mobilization and allocation of financial resources clearly take place within organizations as well as in markets, a study of the financial system as that consisting solely of financial markets presents only a partial picture of the mobilization and allocation of financial resources that take place in any market economy. We therefore need a theoretical framework which encompasses the role of organizations, including the government, in credit allocation

2-b. Markets and Organization

The theoretical foundation for such a framework exists in the new institutional economics (Williamson 1975, 1985). The core insight of this literature is the pervasiveness of transactions costs, and the role of organizations and organizational innovation in reducing them. In a capitalist market economy, organizations, including the firm, emerge because they are more efficient in carrying out certain economic transactions than markets.

[11] There are, however, some exceptions. For example, what is called "Chaebol" in Korea is a large multi-unit enterprise and can be thus viewed as possessing an efficient internal capital market

The advantages of internal transactions, i.e., transactions taking place within an internal organization, relative to that of market transactions include the ability of internal organization to better handle informational imperfections. Firstly, because of its hierarchical structure which allows the specialization of decision making and economizes on communication costs the internal organization is able to extend the bounds of rationality. Secondly, the internal organization is able to reduce uncertainty by coordinating the decisions of interdependent units to adapt to unforeseen contingencies. Since financial transactions are especially subject to moral hazard and costly contract enforcement, we would expect organizations to be particularly likely to develop, functioning as an internal capital market for allocating financial resources.

The efficiency of internal organization relative to markets has been extensively analyzed by Williamson (1975) in terms of transactions costs. There are, however, a number of reasons why private internal organizations which have evolved over time to economize transactions costs in a capitalist market economy would function differently from an institution created by the government or the government itself. A particularly critical issue in this regard concerns the possibility of rent-seeking behavior. Neoclassical political economy emphasizes that a major source of inefficiency is the ability of business and government to effectively collude through the provision of rents which advance the interests of politicians, bureaucrats, and their private sector clients at the expense of the welfare of the entire society. Yet it is important to underscore that opportunism is a characteristic of market transactions as well; indeed, the transactions cost literature assumes what Williamson has called "self-interest with guile." Moreover, rent-seeking relations are also visible within firms, and though the existence of hierarchy does not eliminate them, it can mitigate them through effective monitoring and sanctioning.

The major point to be made here, however, is that by regarding a financial system in which the government plays an active role as an internal organization, we admit the possibility that it can be more efficient than the market system of credit allocation; this alone is a significant departure from the conventional treatment of such a financial system which takes nonprice-mediated transactions as ipso facto inefficient.[12] The crucial question centers on the *conditions* under which a quasi-internal organization will, in fact, be more efficient.

2-c. The State and Large Business—A Quasi-Internal Organization[13]

Patrick (1990) correctly points out that for a "highly-competitive, market-based financial system" to work efficiently, there must be an adequate institutional infrastructure. There must be a system of laws, regulations, and courts; an efficient information system which minimizes uncertainties and costs of financial

[12]Resource allocation in a market economy takes place in both markets and internal organizations, and allocative mechanisms used even in the market and within the firm are often a mixture of the pure market principle and the pure organization principle. Market principles penetrate into the internal resource allocation and organization principles enter into the market allocation to remedy the failures of pure principles either in the market or in the organization (Imai and Itami 1984)

[13]The basic idea presented in this section is more fully discussed in Lee (1992)

intermediation; prudential regulation ensuring the stability of the financial system and protecting depositors; and government supervision minimizing moral hazard. Patrick does not, however, discuss how this institutional infrastructure comes to be established, nor the choices governments confront between developing these institutions for the purpose of supporting market transactions, and substituting for them through alternative organizational means.

For reasons outlined above, it is possible for an internal organization with an internal capital market to perform the tasks required of this institutional infrastructure more efficiently. Thus, the question facing a developing country is whether it should invest in building the institutional infrastructure to support markets or devise an alternative system bypassing the imperfect financial market. That is, the issue is whether or not investing in making the imperfect market less imperfect is necessarily the best policy for a developing country.

The financial system even of an advanced developed country consists of both market and non-market institutions, and as pointed out, private internal capital markets develop because of market imperfections and transactions costs. In developing countries, however, private internal capital markets may not be efficient because of the limited size of their enterprises or they may not serve the developmental objectives of the state. In either case, the government may create an internal capital market of its own in an attempt to improve the efficiency of credit allocation. If a government-created internal capital market is to succeed as an efficient institution, however, it is likely to share features that are typical of those private institutions which have evolved and withstood the test of time in market economies.

The structure of a hierarchical system of credit allocation consists of the government and enterprises receiving credit allocated by it. There may be financial institutions that function as intermediaries between government and enterprises but in this hierarchical system their role is essentially that of distributing credit as directed by the government planners. As financial intermediaries and firms are not (necessarily) legally bound institutions, and as some transactions are clearly price-mediated, the organization consisting of the government, financial intermediaries and the recipient enterprises may be called a "quasi-internal organization."

It needs to be pointed out, however, that the fact that the quasi-internal organization can function as an internal capital market does not necessarily mean that funds will be allocated efficiently; this will depend on the objectives of the political leadership and the internal structure of the quasi-internal organization. In the literature on the firm, the commitment of management to profitability is ultimately supplied by the market. The choice of a wrong product or technique may lead a firm to fail. Market competition ensures the survival of only those that, on average, choose the right products and production techniques. Through the monitoring of performance, shareholders and boards are also capable of punishing and rewarding executives not committed to increased profitability.

These checks may not operate to restrain governments, however. First, the quasi-internal organization does not face the competition that private firms face in the market. As it is the only such organization in the economy, it enjoys a monopoly position. Like a monopoly, the quasi-internal organization may prove "efficient" in achieving its own narrow objectives, but at the expense of the rest of the economy. Moreover, unlike the model of the firm in which shareholders and board members monitor performance, there are typically imperfections in the political market that prevent political leaders from being punished for bad performance. This is true of some authoritarian governments, but it may also be true in democracies where powerful lobbies are capable of capturing policy for their benefit.

There are, however, mechanisms that can serve to constrain socially inefficient credit allocation. The first has to do with the broader policy setting in which the quasi-internal organization operates. If the government is committed to an outward-oriented strategy, the dependence of the economy on external markets can act as a check on government financial policy. Import-substitution policies, by contrast, remove this check.

For a small developing country committed to an outward-oriented development strategy, prices are parameters determined by the rest of the world. The government cannot thus arbitrarily change prices to cover the consequences of an inefficient allocation of credit. Because of this constraint, an inefficient internal allocation of credit which supports wrong projects will result in financial losses for the constituent enterprises. They may be able to survive with subsidies from the government, but their losses are financial losses for the quasi-internal organization. Thus, whether subsidized or not, the quasi-internal organization will suffer financial losses, and thus face pressures to correct its pattern of credit allocation. In other words, the quasi-internal organization in a country committed to an outward-oriented development strategy faces one equivalent of a "hard" budget constraint.[14]

In contrast, a small developing country which has adopted an inward-oriented development strategy can alter prices to cover the consequences of misguided internal credit allocations. Potential losses of the constituent enterprises can be made to disappear by changing prices with little noticeable effect on the treasury, at least in the short run. The quasi-internal organization can avoid making losses resulting from wrong credit allocations, and there is thus little or no incentive or compulsion to correct the existing pattern of allocation. Such a quasi-internal organization operates under a "soft" budget constraint.

As market competition is necessary to ensure the survival of efficient private internal organizations, so is competition necessary to ensure that the quasi-internal organization committed to economic growth makes efficient allocation of credit. For the quasi-internal organization, such competition exists only if it is exposed to competitive forces in world markets. For this reason it is essential that the country is committed

[14]This point that a commitment to an outward-oriented trade strategy imposes a constraint on policies and makes the costs of policy mistakes quickly visible has been also noted by Krueger (1990a)

to an outward-oriented development strategy; this commitment imposes the market discipline on the quasi-internal organization.

This characterization suggests some of the *organizational* conditions that are likely to be important in making the quasi-internal organization effective. First, it is crucial that the government not be politically captured by the firms. Where the government and the financial decision-making process is captured by constituent firms--as it is in many developing countries--the conditional nature of credit provision breaks down

Second, the nature of the contract between the government and the firm must be clear and measurable. Moreover, the government must possess control techniques not only for monitoring private sector behavior, but for bringing sanctions to bear in a selective manner on agents that fail to live up to contracts.[15] This problem of managing the principal-agent relationship, in turn, demands a relatively well-developed bureaucratic apparatus.

Finally, the structure of business is likely to matter as well. Implicit in the foregoing analysis is the assumption that the number of constituent enterprises within the quasi-internal organization is not so large as to make monitoring costly. As the quasi-internal organization expands, it is more likely to run into organizational failures and may lose its relative advantage over markets

2-d. Conditions for Efficient Government Intervention

We have argued that, given the inherently imperfect nature of financial markets, financial "repression" in certain countries may be interpreted as an effort on the part of the government to create its own internal capital market for mobilizing and allocating financial resources for its developmental objectives. Drawing on the analogy of the emergence of internal capital markets in market economies, we have suggested several theoretical reasons why this government-created internal capital market can be relatively efficient, as well as the empirical conditions under which it is likely to be so.

First, the quasi-internal organization is likely to be more efficient where the government is committed to economic growth and to an outward-oriented growth strategy that both restrains it and provides information on the soundness of its investment choices. Second, the contracts with the private sector must be clearly specified and measurable, and the government must be politically and organizationally "strong" enough to monitor and enforce those contracts through sanctions Third, the quasi-internal organization is likely to be more effective where the number of private sector actors is limited.

[15] It is important to note that the government in the quasi-internal organization is capable of rewarding desirable behavior by penalizing undesirable behavior on the part of constituent enterprises in a consistent manner as in a private internal organization If the government is incapable of doing so for one reason or another, its relationship with private enterprises cannot be called that within the quasi internal organization The importance of incentive-compatible mechanisms in designing the proper microeconomic role of government was recently discussed by Krueger (1990b)

These are clearly formidable conditions for many developing countries, and only a few have the political and bureaucratic capabilities that would enable them to meet these conditions.[16] These conditions suggest that for most developing countries, the risks of government failure probably outweigh those of market failure, and that attempts to correct the latter through government intervention may only make the situation worse. What, however, seems clear is that strengthening the political and bureaucratic capabilities of a developing country is as important as improving the functioning of its markets if it is to achieve economic development.

IV. INDUSTRIAL DEVELOPMENT IN TAIWAN

Industrial development in Taiwan has not been a process determined solely by the private sector either. It has been influenced, albeit less strongly than in Korea, by the government that believed in helping the economy move through the successive phases of industrial development (Ho 1981, Scitovsky 1990, Wade 1990).

1. Policies for Industrial Transition

1-a. From Primary Import Substitution (1950-1962) to Primary Export Substitution (1962-1970)

Through 1958 Taiwan's trade regime was oriented basically toward promoting import substitution in small-scale, labor-intensive industries. High tariffs were levied on finished and luxury products, and a licensing scheme was in place to restrict imports. They were further discouraged with the requirement that importers make an advance deposit of the full value of imports in domestic currency.

A multiple exchange rate system was in operation with the rates depending on the type of imports and the source of foreign exchange. A higher exchange rate was applied to imports other than those of basic raw materials and industrial products financed from US aid and imports by state-owned enterprises.

In the case of a number of industrial investments the government first conducted feasibility studies, then invited interested private entrepreneurs to participate with the offer of low-interest loans. Sometimes the government acted as the sole investor in a manufacturing facility which it then turned over to private investors. It also provided special loans through state-owned banks to certain private enterprises facing particular difficulties.

[16] Clearly, Korea did have most of these conditions According to Kim and Leipziger (1992), the Korean government had a clear vision of its industrial goals, an ability to control the economy through both direct and indirect methods, a willingness to socialize some of the business risks, and an excellent ability to create institutions such as development banks, trade promotion agencies, and general trading companies, and an ability to make pragmatic decisions It also had an able bureaucratic and planning apparatus and a unique relationship between the government and business which helped in designing and implementing economic policies It should be pointed out, however, that Korea had these conditions only after 1961 and the situation before then was quite different (Haggard, Kim and Moon 1990)

The Bank of Taiwan, the largest commercial bank in Taiwan, accounted for one-third of total bank deposits and lending in the 1950s and performed the function of the central bank. It also acted like an industrial bank in the 1950s, extending preferential credit to state-owned enterprises and import-substitute industries, especially textiles. Lending by other state-owned banks also went mostly to state-owned enterprises and to the public sector for investment in social infrastructure. Credit allocation was, however, only a secondary instrument for import-substitution policy, the primary instrument being the allocation of foreign exchange and the control of industrial permits (Cheng 1993).

These trade and financial policies encouraged the flow of resources into import substitution and contributed to the doubling of manufacturing output between 1950 and 1958.[17] The growth rate, however, slowed toward the end of the fifties as it reached the limits of domestic markets. By then, moreover, many of the manufacturing industries became burdened with excess capacity.[18] Excessive investment in productive capacity might have been a result of over-confidence on the part of domestic entrepreneurs, but the policy of providing undervalued foreign exchange for imported raw materials and capital equipment was a contributing factor (Liang and Liang 1981).

There are two interesting points to be noted about the industries with excess capacity. The first is that they were the industries producing simple manufactured goods such as rubber canvas shoes, electric fans, soap, insulated wire, plywood, synthetic fabrics, woolen yarn, sewing machines, iron rods and bars, and paper. The second point is that many of these industries soon became Taiwan's main exporting industries. In fact, the industries producing textiles, basic metals, clothing and footwear, and plywood were the top four manufacturing exporters throughout the 1960s. Thus much of the export growth that took place during the primary export substitution phase came from the industries that had expanded--in fact over-expanded--during the period of primary import substitution.

Given these observations it is difficult not to draw the conclusion that the import-substitution policy of the 1950s must have laid a foundation for the export boom of the 1960s. But, this foundation alone was not enough for Taiwan to experience an export boom during the period of primary export substitution. It also had to carry out a change in trade policy from import substitution to export promotion, which might have been gladly supported by the industries now suffering from excess capacity. Having reached the limits of domestic markets these industries would have welcomed the helping hand of the state to expand markets abroad.

[17] It should be noted that substantial industrialization and import substitution had begun in Taiwan well before the early 1950s under the Japanese colonial rule and that in part because of the inflow of migrants from the mainland there was a sound human and physical infrastructural base for industrial development (Ranis 1979)

[18] In 1959 the rate of capacity utilization ranged from 23 3 percent for rubber canvas shoes to 67.4 percent for paper. In 1970, about ten years after the change in trade policy, it was higher in general, ranging from 51 2 percent for sewing machines to 100 percent for woolens. The only exception was in the sewing machine industry where the rate of utilization decreased from 64 3 percent to 51.2 percent betwen the two years (Liang and Liang, 1981, table 1)

In 1958-59 the Taiwanese government introduced major policy reforms, which began with the promulgation of the Program for Improvement of Foreign Exchange and Trade Control in April 1958. It basically reversed the orientation of trade policy opting the course of promoting exports from light manufacturing industries instead of establishing heavy and chemical industries. This choice was made, according to Li and Yeh (1981), because the government recognized that Taiwan then had neither the financial and technological capabilities nor large enough domestic markets for heavy and chemical industries. It was thus decided first to promote labor-intensive manufactured exports and to postpone the secondary import substitution till the domestic demand for intermediate products warranted their establishment. The measures promoting exports from light manufacturing industries took several forms.

First, the overvalued currency was devalued and a dual rate system consisting of the official exchange rate and the exchange certificate rate replaced the multiple exchange rate system. Exchange certificates, which were transferrable and fully useable for imports, were given to export proceeds and inward remittances, and their rate was determined freely on the market. In June 1961, however, even this dual rate system was simplified into a unitary rate system.

Second, the reform initiated in April 1958 also included reduction of tariffs and elimination of strict controls on foreign exchange allocation. The quota system became liberalized, being abolished eventually, and restrictions on imports of materials and equipment for export use were substantially eased.[19]

Third, in addition to liberalizing imports the reform introduced various export incentives. These included rebates of customs duties and commodity tax on imported raw materials, exemption from business and related stamp taxes, special low interest loans for export production and for raw imports, and government-provided export insurance. Also provided were income tax provisions favorable to export activities such as the exemption of 2 percent of annual total export earnings from taxable income and 10 percent tax reduction for enterprises that exported more than 50 percent of their output.

In industries such as cotton spinning, steel and iron, rubber products, monosodium glutamate, woolen and fabrics, and paper and paper products, manufacturers' associations provided direct subsidies to exports. These subsidies were financed with private levies on domestic sales or on materials used to manufacture for domestic markets.[20]

The shift in trade strategy from import substitution to export promotion was accompanied with a shift in emphasis from the expansion of the state sector to the expansion of the private sector in manufacturing. The share of loans and discounts advanced to private firms rose sharply with a majority of bank loans financing

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[19]According to Hou (1988), the import substitution policy which was adopted in the 1950s has never been dismantled and Taiwan has had in fact a mixed trade orientation although outward-orientation has gained more and more importance beginning in the 1980s

[20]In industries such as textiles, canned mushrooms, canned asparagus spears, and citronella oil trade organizations, which were established with the government's encouragement, controlled production and export by means of export quotas and unified quotations of export prices, thus preventing costly competition among many small exporting firms which would otherwise have lowered their export prices

export activities. Export financing was not selective between industries and was automatically extended on the basis of export shipping documents. Development financing, albeit in limited amounts, went to former import-substitution industries such as textiles, glass, and plastics (Cheng 1993).

An important point to be noted about this change in trade policy is the fact that there were still many manufacturing industries protected with tariff and nontariff barriers. Conditions for protection became, however, progressively stringent as they were designed to promote the international competitiveness of the protected industries. Thus manufacturers seeking protection from import competition were required to demonstrate that the quantity and quality of their products were adequate to meet the domestic demand. Even when protection was granted, a declining schedule of an upper limit was imposed on the margin between the price of the protected product and the duty-inclusive price of a comparable import. Thus in 1960 the ex-factory price of the protected product was allowed to exceed the price of a comparable import by no more than 25 percent. But in 1964 this margin was reduced to 15 percent, to 10 percent in 1968, and to 5 percent in 1973. Protection was thus provided only temporarily to give domestic manufacturers the time necessary for improving their competitiveness, and this was clearly understood by those seeking protective measures from the government

1-b. Secondary Import Substitution (1970-1983)

The development of heavy and chemical industries was already mapped out in the Third Plan (1961-64) and the Fourth Plan (1965-68), but the actual push for their implementation had to wait for the right conditions in the domestic economy. By the end of the 1960s these conditions emerged as the light manufacturing venture with two U.S. firms to produce fertilizer. Similar arrangements were also made in the case of lubricating oil and low-density polyethylene (Wade 1990, p. 91).

The story of what the state has done in the development of the heavy and chemical industries in Taiwan is all too well documented by Wade and need not to be told more than what has been presented in these pages. The message, as in the following quote, is basically that the development of these industries was led by the state, not by the market.

> In many sectors public enterprises have been used as the chosen instrument for a big push. This is true for the early years of fuels, chemicals, mining, metals, fertilizer, and food processing; but even in sectors where public enterprises did not dominate, such as textiles and plastics, the state aggressively led private producers in the early years (Wade 1990, p. 110).

In the high-tech industries we again see the same active role by the state. In semiconductor business, for instance, the government created in 1974 two joint-venture firms, United Microelectronics and Taiwanese Semiconductor Manufacturing Company, as well as some key state agencies for research and development.

In setting up these companies the government provided virtually everything including plant, equipment, technologies, and manpower as well as making equity participation. An interesting point to be noted here is that the government tried hard to induce voluntary private participation but found no private firms that were willing to enter into the semiconductor business in the early stages of the industry (Hong 1992).

Subsequently, however, some private firms joined the industry but with the help of the government. Six semiconductor firms were established by former employees of state-run research institutes and with the help of technologies directly provided by the institutes. Since 1989, however, the industry has become predominantly private as it was joined by many foreign subsidiaries or joint venture firms which rely on parent companies for necessary technology.

The chief comptroller, the secretary general of the Executive Yuan (Cabinet), and the governor of the Central Bank, met once a week since 1974 to discuss policies, coordinate various sectors in the economy, and make policy recommendations directly to the premier. In 1977 FEC was merged with the Economic Planning Council to become the Economic Planning and Development Council, a super-ministry level organization. Underlying the institutions such as FEC was the view held by government officials and planners that market signals were not adequate to allocate resources in the best interest of the country and that they needed to be, therefore, supplemented with government intervention but in a market-conforming way (Myers 1990).

In many countries, whether developed or developing, state-owned enterprises tend to be inefficiently run and thus require a frequent injection of state subsidies. What is, therefore, remarkable, is that in Taiwan the same enterprises seem to have been by and large efficient and thus have avoided becoming a drag on the economy. A fundamental reason for this is that the state, which is perennially obsessed with macroeconomic stability and has thus basically followed conservative monetary and fiscal policies, has imposed a hard-budget constraint on the state-owned enterprises. This conservatism has its root in the bitter experience of the KMT on the mainland (Cheng 1993).

The hyperinflation, which was caused by rampant fiscal deficits and the abuse of monetary authority, contributed greatly to the collapse of the KMT regime on the mainland. This bitter lesson of hyperinflation and its consequences was indelibly etched in the minds of the KMT political elite and was reflected in the establishment of a strong, autonomous central bank with conservative monetary and fiscal policies. The regime in Taiwan was not about to repeat fiscal and monetary irresponsibility by subsidizing inefficiently run state-owned enterprises and thus bring about its own collapse.

One important feature of the quasi-internal organization in Taiwan, in comparison with that in Korea, is that as an internal market for resource allocation it has become less important sooner than in Korea. This has happened because of the diminishing importance of the state-owned enterprises: its share of Taiwan's industrial production was more than 51 percent during the 1952-61 period but was reduced to a little over 19 percent by 1972-81 (Yu 1988). In Korea, in contrast, the share of GDP accounted for by large private enterprises became larger over the same period. for instance, between 1977 and 1983 the share of shipment of the top 30 large business groups in manufacturing increased from 34 percent to 40 percent (Lee 1986).

2-b. Finance in Industrial Development

The fact that the quasi-internal organization in Taiwan consists of the government and the state-owned enterprises does not mean that the private sector has been spared of the direct influence of the government. Through its ownership of most of the domestic banks it has affected credit allocation and thus the flow of resources in the economy.

Taiwan's decolonization and the Kuomintang regime's relocation from the mainland put the state in the position of assuming direct control over the financial system. It controlled the appointment of the senior staff of the banks, the structure of interest rates, and the size and type of loans. Although its control has been somewhat loosened since the financial liberalization that began in 1986, the government still have strong influence over the banks' credit allocation as their personnel still remain as civil servants

Indirect finance--mostly by domestic banks--has been the primary source of funds for business enterprises. Among the domestic banks, the state-owned banks have far outweighed the private banks, accounting for 80.0 percent of total lending in 1963 and 67.4 percent in 1986 and accounting for 76.8 percent of total deposits in 1967 and 66.6 percent in 1986. It is clear that much of credit in Taiwan was allocated by the state-owned banks and how it was allocated by them, therefore, had a significant effect on Taiwan's economic growth. The banks tended to make loans to state-owned and large private enterprises, and the following three factors are offered for this tendency (Chou 1993).

The first is a regulation on the ratio of bad loans or overdue loans to total loans. This ratio has been used not only for evaluating management performance but also for approving a request for opening new branches, which were highly profitable in the protected banking industry. The banks, therefore, had a very strong incentive to abide by the regulation and keep the ratio low (less than 2 percent in 1984), and in order to do so they tended to require large collateral, which was more easily provided by large than small private enterprises.

The second factor is the minimum profit requirement which depended, among others, on the individual bank's past performance and government revenues. Profits of the state-owned banks were an important source of government revenues, and the excess profits over the required amount were used as the sole criterion for bonuses given to bank employees. This requirement led the banks to adopt the conservative lending practice of demanding large collateral and large compensating deposit balances on their loans., A third factor--lack of reliable credit information--has further aggravated this tendency for conservative lending. It is widely accepted in Taiwan that private enterprises maintain several editions of financial statements--one for the tax authority, another for the bank, and perhaps the true one for the owners themselves. Being fully aware of this practice, the banks tended to discount whatever information contained in financial statements nd relied on the collateral offered with loan applications in making loan decision.

Of course, the fact that the banks tended to make loans to state-owned and large private enterprises does not necessarily mean that credit allocation was not used for industrial policy. During the period of primary import substitution credit policy was deliberately used to promote specific industries or even specific firms. This was not the case during the subsequent primary export substitution period when, as in Korea, policy loans were broadly targeted to support exports and rarely to promote specific industries. During the 1970s, however, the government did resume financing new or expended state-owned enterprises for secondary import substitution

To accelerate the pace of industrial development the government began in 1982 to authorize strategic industry loans managed by development banks. These loans, however, accounted for only 4.3 percent of total loans dispensed by state-owned banks in 1988, and their importance was soon superseded by special purpose loans (Cheng 1993). Since they were mostly for the purchase of domestically produced machinery, automation for industrial upgrading, and anti-pollution equipment, special purpose loans as well as strategic industry loans would have to be regarded as having had the effect of facilitating secondary import substitution.

Another source for development financing is postal savings. Before February 1982 postal savings were redeposited in the central bank. But since then, some of the new deposits have been routed to certain domestic banks and used for financing industrial upgrading and diversification. Credit facilities in support of industrial upgrading and diversification included long-term, low-interest rate loans for strategic industries and for broad types of investment in anti-pollution devices and automation and the purchase of locally produced machinery and software.

In spite of all this involvement of the state in financial markets developmental financing has never been a salient feature of Taiwan's financial policy. It is not that economic technocrats did not push for the use of preferential, selective credit policy for the promotion of strategic industries. What actually determined the institutional design and credit policy in Taiwan was, however, the political calculus of the KMT leadership. Being aware of the sub-ethnic cleavage and the alien nature of the KMT regime in Taiwan it could not afford any possible challenge from family-controlled, predominantly native Taiwanese industrial groupings. It thus found preventing their emergence much safer to the regime's hegemony than keeping them under control through credit allocation, as in Korea. Thus for industrial development the state in Taiwan has relied primarily on state-owned enterprises not only in the initial stages of industrial development but also in the development of large-scale heavy and chemical industries such as upstream petrochemicals (Cheng 1993).[22][23]

V. CONCLUSION

This paper has examined the role of the state in economic development in Korea and Taiwan. Clearly both Korea and Taiwan adopted an outward-oriented development strategy early in the 1960s, which contributed to the accelerated pace of industrial development in these countries. But too often by focusing on this policy and its immediate affect on trade and economic growth the larger, but evolving, role that the state has played in these countries has tended to be neglected. The fact is that at least in the early stages of industrial development the state did much more than to change its trade policy and wait for latent comparative advantage to exert itself. State actions preceded the change in trade policy in the early 1960s and had the effect of preparing the economy to respond quickly and dynamically to the market opportunities provided by the change in trade policy.

One of the key functions performed by the governments in Korea and Taiwan is to help create supply-side conditions necessary for exploiting world market opportunities. It has not relied solely on markets to reveal latent comparative advantage; it has helped them to realize whatever comparative advantage the country had by directing resources into the areas of latent comparative advantage as well as promoting private investment into the area.

Such a role by the state is conceptually inadmissible in the standard neoclassical economics. A point made in this paper is that such a role is, however, perfectly admissible once the government and large enterprises in Korea and Taiwan are viewed as quasi-internal organization. Viewed in this way, direct government intervention is an internal transaction comparable to a transaction taking place within a private internal organization, and consequently it can be efficient (or inefficient) for the reasons why a private internal transaction can be. In other words, once the government and large enterprises are regarded as a quasi-internal organization state intervention is not necessarily inefficient and under a certain set of conditions it can make a positive contribution to economic development.

The experiences of Korea and Taiwan point out that for state intervention to make a positive contribution to economic development the state needs to have developmental objectives and a bureaucracy

[22] The political ideology of the KMT provides a clue to its leaders' interest in guarding against the private sector The KMT regime was an authoritarian one but the party was like a Leninist one, carrying an ideology of statist capitalism, *min sheng chu i* [the principle of people's livelihood], a doctrine invented in the 1920s by Sun Yatsen, the founding father of modern China As espoused by the KMT regime, *min sheng chu i* promoted state capital and restrained private capital, but the onset of the Cold War and the alliance with the United States, in particular, led the KMT regime to promote private capital (Cheng 1993)

[23] Some credit allocation has been made to support private enterprises in a few strategic industries But the beneficiaries of strategic industrial policy loans were young engineers-turned-entrepreneurs in the electronics industry and little-educated, apprentices-turned-entrepreneurs in the machinery industry Both were new capitalists unrelated to established industries, running basically small and medium-sized enterprises Since they did not resent much of a threat to the KMT regime the political leadership could approve the financing scheme for such industries proposed by the technocrats (Cheng 1993)

capable of formulating and implementing policies aimed at those objectives.[24] But the role of the state is an evolving one, supporting and in certain cases leading the private sector in the early stages of development but diminishing in importance as the economy develops and the private sector becomes more efficient in allocative decisions. The simple dichotomy between the state and the market is a false one as there are many shades to state intervention and as proper intervention can make a difference to how a basically private market economy may develop.[25]

A key lesson to be drawn from the experiences of Korea and Taiwan for the developing economies in Africa is that setting up a neutral, unbiased incentive system is unlikely to be a sufficient condition for economic development. Market-supporting institutions need to be established, and technology and know-how need to be acquired And these take both time and scarce resources, and to rely entirely on the market may take too long for the viability of any political regime in developing Africa. A secure political regime which is immune from political repercussions, like the colonial government of Hong Kong, may be able to limit its role only to providing necessary social overhead capital and to maintaining an overall environment conducive investment. The governments in many developing countries may not have such luxury. given the enormity of the consequences that might follow from political instability; it would be tragic if governments in the developing countries in Africa abstained completely from any intervention because of their misunderstanding of the causes of the East Asian success.

[24] Amsden (1992) agrues that a precondition for such a developmental state is a relatively equal distribution of income One reason for this is that for the industrialization of a developing country the government needs to subsidize business as it lacks pioneering technology but then it must discipline subsidy recipients. A relatively equal distribution of income will prevent the state from being controlled by a few and being used for their own rent seeking Another reason is that equality motivates managers and workers towards improved productivity.

[25] Datta-Chaudhuri (1990) sees the role of the state as that of promoting and supporting the right kind of market institutions. The experiences of Korea and Taiwan show that the state can also be a member of a market institution called a quasi internal organization.

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LATIN AMERICAN EXPERIENCE WITH ECONOMIC POLICY REFORM

The Cases of Argentina and Chile

Rolf Lüders

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LATIN AMERICAN EXPERIENCE WITH ECONOMIC POLICY REFORM
The Cases of Argentina and Chile

Rolf J Lüders[1]

Most developing countries are searching for the "best" economic development model In this endeavor, research of a purely theoretical nature, or through comparative empirical and/or case studies, is useful It is therefore that the cases of Argentina and Chile might contribute to enlighten the economic policy debate in Africa, Asia and other developing regions, since decades ago both these countries adopted protectionist policies and governments intervened heavily in the economy by other means, trying to accelerate the rate of economic growth and to reach a more equal income distribution Instead they distorted the allocation of resources and destroyed to a large extend the naturally existing incentives to save, invest and work

However, starting in the 1970s in Chile, and in the late 1980s in Argentina, both economies were significantly deregulated as a reaction to the deepness of crisis which can, in significant part, be attributed to the mentioned economic policies This paper attempts to draw some policy lessons from these two cases, which constitute almost laboratory experiments, useful to other developing countries.

Table 1 reflects the problem Chile and Argentina faced during the 1950-1970 period. Their economies, measured on the basis of per capita income, were growing at about the same rate as the U S A , and significantly slower than the better performing developed and developing countries, including Brazil and Mexico. Both of the former Latin American economies are and were relatively richly endowed in human and natural resources, which made the poor performance even more unexplainable to the population. Eventually the cause of this slow rate of economic growth was attributed to the prevailing import substitution policies and one of its most significant consequences, discriminatory government intervention and rent seeking

After the socio-economic and political crisis of 1970-1973 which resulted in the military intervention, Chile implemented a so called Social Market Economy, a market economy in

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which the government intervenes mainly to equalize opportunities of citizens and to overcome gross market imperfections . Argentina experienced a long and lingering economic crisis after the debt problem erupted in the early 1980, which eventually resulted in hyper- inflation. A change in government at that time, was followed by a drastic anti-inflationary program and a significant deregulation of the economy, and that country has now, as a result, an economic model which is very similar to that of Chile.

Table Nº 1: Economic Growth Performance of Selected Countries

	GDP per capita as % of US GDP per capita					GNP per capita average annual growth rate
	1950 *	1960 *	1970 *	1980 *	1991 **	1980-1991 ***
Argentina	41	41	41	40	23	-1.5
Chile	31	32	32	30	32	1.6
Brazil	14	18	18	27	24	0.5
Mexico	24	27	30	32	32	-0.5
Thailand	10	9	12	15	24	5.9
Korea	-	12	17	25	38	8.7
Taiwan	10	13	20	31	-	-
Japan	17	33	64	72	88	3.6
Germany	40	71	79	86	89	2.2

Years marked * are from Summers, R and Heston, A (1984), and are based on Purchasing Power of Currencies
Year marked ** is from The World Bank (1993), and is based on Purchasing Power of Currencies
Period marked *** is from The World Bank (1993), and is based on nominal exchange rates

This paper first describes the import substitution policies most countries in Latin America adopted after the 1940s[2], and the main consequences of it, as a background section to the debt crisis and the structural reforms of the 1980s and early 1990s. The second section provides some basic information about the Argentine and Chilean economies at present, for those who are not familiar with them. The third section describes the Chilean structural reforms in some depth, and the fifth section summarizes those in Argentina. The fourth section provides an explanation for the significantly different response to the debts crisis of the Latin American and some Asian economies, in terms of the import-substitution and the market models adopted in those countries, respectively. The last section draws some lessons from these experiences.

[2] Although the degree of protection varied a great deal, as well as the period of implementation. The "movement" started, in general, at the Southern Cone and expanded to the north.

ARGENTINA, CHILE AND THE LATIN-AMERICAN IMPORT SUBSTITUTION DEVELOPMENT STRATEGY OF THE 1940-1980 PERIOD

Latin America, as the rest of the world, was severely affected by the Great Depression of the early 1930s. This depression originated in the U.S.A. and was transmitted all over the globe through a sharp reduction in trade and capital flows. As a rule, the more open countries were to international trade and capital flows, the more they suffered as a result of the recession. Most of Latin America followed at the time relatively liberal trade policies, and therefore they were severely hit by the recession In some cases, the effects were even more devastating than in the U S.A. For example in Chile, exports fell by 80 per cent between 1930 and 1934, while GDP dropped by 45 per cent between 1929 and 1932 [3] It is not surprising that as a result protectionism rapidly gained ground .

Soon afterwards World War II broke out, and the industrial countries reoriented their production to military purposes. This generated significant shortages of manufactured consaumption goods in the international markets. Again, most Latin-American countries were severely affected, since they tended to export foodstuffs and raw materials, and import processed products. So much so, that import substitution policies, which were beginning to be accepted as a reaction to the effects of the Great Depression, were in fact forced on them during the war

After the war and as a result of interest group pressures which by that time had developed, several of the mayor and most influential countries of the region, especially those in the Southern Cone, continued to apply import substitution policies, and these eventually spread all over Latin America In this last endeavor, the Economic Commission for Latin America (ECLA), and especially its Executive Director, Doctor Raúl Prebisch, played a mayor role, since they provided an extremely well articulated justification for the process[4].

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[3] Jeftanovic, P., Lüders, R. and Paglia, M. (1992)

[4] Evidently policies in Latin America, as everywhere, are the result of a complex political process, in which interest groups are not absent The ECLA doctrine played a dual role in the process on the one hand, it influenced the believes of most of the "experts" of the time, both within governments as well as in the Private Sector, and on the other hand, it provided a respectable intellectual basis for business groups interested in receiving protection.

The import substitution doctrine[5]

Prebisch divided the world into two groups: the *center*, which according to his view was rich, generated all technological progress, and produced industrial goods, which have relatively high income and price elasticities of demand; and the *periphery*, which was poor and produced raw materials, which have low income and price elasticities of demand. Given the price elasticities just described, technological progress[6] in the industrial sector generated income growth at the center, because the increased production could be placed at only slightly lower prices. Instead, technological progress applied to raw materials only resulted in lower prices, given their low price elasticity, and this also benefited the center, the main purchaser of these products. In summary, according to the ECLA doctrine of the time, technological progress, the basic source of income growth, resulted always in *higher income for the center and lower export prices for the periphery* This explains, according to the argument given, the *declining terms of trade*[7] the developing countries face[8].

Moreover, as income growth takes place, given the above described income elasticities of demand for industrial products and raw materials and according to the import substitution doctrine, the developing countries are bound to have continued *balance of payment crisis*. Growth at the periphery, generated of course by capital accumulation and not by technological progress, implies according to the ECLA doctrine, a sharp increase in the demand for imported industrial products, while at the same time growth in the center does not imply a corresponding increase in the demand for raw materials, the periphery's exports. Traditional solutions to these balance of payments crisis, such as reductions in aggregate demand managed by the Central Bank or the Ministry of Finance, only result in income reductions. Since, following Prebisch, these solutions are unsatisfactory, alternatives have to be sought

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[5] See Lüders, R. (1976) for a more detailed description and critical analysis

[6] For these purposes technological progress is defined as generating more output for the same quantity of inputs.

[7] Defined as the prices of exports divided by the prices of imports.

[8] Prebisch, an Argentine citizen, picked up the notion of the historic declining trend in the terms of trade for the developing countries, as a result of the study he made of those facing Argentina with respect to Great Britain starting around the 1830s. Since the time Prebisch developed his doctrine, the terms of trade facing Latin America have fluctuated severely, but it is not possible to talk about any definite positive or negative trend (see Massad, C. (1986)) If one introduces supply conditions of raw materials (often inelastic), which Prebisch did not do, it is easy to explain increasing terms of trade if the world economy growth fast enough.

The answer provided by ECLA was simple: apply policies to divert additional resources from export production to import substitution[9]. The periphery had, as described above, a certain monopoly power over raw materials, which could be exploited[10]. The classic prescription for a country facing such a power, is to impose an export tax, which will result in higher prices and lower output If faced with an inelastic price elasticity of demand for its export product, as, according to ECLA, was the case of the periphery, this tax would in addition result in increased export revenues It can also be shown that under certain conditions, an import tax has the same effect on exports as the equivalent export tax. Prebisch proposed to apply an import tax to induce resource owners in the periphery, as well as foreign investors, to increase relatively their investment in the industrial sector to substitute for imports, and therefore to reduce it relatively in the raw material producing sector This *import substitution policy* implies, it was argued, a higher value of exports and at the same time the release of resources to be devoted to industrial production, that is, an overall higher income level

As noted in some of the footnotes, the ECLA doctrine, and especially its policy description, is based on false premises The terms of trade do not necessarily move against the developing countries, as the Latin American experience since the 1950s shows; there is no such thing as *one* periphery, but many developing countries which persue their own trade policies, the so called center does not only produce industrial goods, but, especially in the case of the U S A , also raw materials and foodstuffs in competition with the so called periphery, etc. Most important from a practical point of view, however, is the fact that a policy prescription devised in the context of a center-periphery framework, was then recommended to individual countries Each country, as opposed to Prebisch's periphery, faces an (absolutely) elastic demand for its products. In such a case, an export tax, or the equivalent import tax, reduces output of the *efficiently* produced raw material output

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9 Up to this paragraph, the description of the ECLA doctrine of the time has followed rather closely the original form of its presentation In this paragraph we use today's standard economic theory terminology, to save space and time This, if anything, tends to make the argument more precise, but in no way changes the course of its basic reasoning

10 A mayor weakness of the ECLA doctrine is the notion of a periphery In fact, the periphery is made up of many countries, which in practice compete one against each other in the supply of the same products Moreover, this dichotomy between the raw material producing periphery and the industrial goods producing center was not even accurate at the time In fact, the center, especially the U S A., is extremely rich in raw materials and foodstuffs, so much so that to talk of a monopoly power of the periphery in but very few products does not make much sense. Even in the case of those few products, petroleum is perhaps one, each country of the periphery has no, or at best an extremely weak, monopoly power Prebisch discovered this later, and than was instrumental in creating the United Nations Commission for Trade and Development (UNCTAD), as a way to coordinate the trade policies of the developing countries.

without affecting its price, while it induces the economy to expand *inefficient import substitution activities*[11].

In spite of its defects, especially if its policy implications are applied to individual countries instead of the periphery as a whole, the import substitution doctrine became the main rationalization of the trade policies implemented throughout the 1940-1980 period in practically all countries of the region[12]. The doctrine was eventually also "exported", mainly to Africa.

The main consequences of the adoption of protectionist trade policies[13]

The result of the application of the import substitution model did not fulfill the expectations of those who favored it Although the economic growth record of the region during the 1940-1980 was acceptable (2 2 per cent per year in per capita income), the performance of different countries was uneven If one excludes the cases of *Mexico*, a latecomer to protection, and a country whose neighbor is the U S A with its huge market, *Brazil*, which abandoned its strong import substitution bias in 1964 when it adopted export promotion measures, *Colombia*, whose protectionist trade policies were always prudent, and some *Central-American* countries, the rest of Latin America has a poor growth record during that period. This is especially true for Argentina and Chile, the two countries which embraced the import-substitution policy with most vigor[14].

The low observed growth rates in those countries which adopted the import substitution strategy reflect not only the already discussed inefficient allocation of resources induced by the implicit trade policy, but also a host of consequences which can be traced back to the policy itself. In general, especially as compared to the successful Asian economies, savings and investment rates were lower, probably because said policy reduced profitable investment opportunities, as well as available savings[15].

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[11] In the case of Prebisch's monopolic periphery the inefficient use of resources in the industrial sector is more than compensated by the increase in prices of the raw material exports This does not happen in the competitive case

[12] Prebisch eventually also recognized that import substitution activities in very small countries could be very inefficient, due to scale He therefore advocated, starting in the 1950s, the creation of a Latin-American Common Market The efforts to create such a market, in spite of the existence of some institutions to this end, has not been successful up to now

[13] See Corbo, V (1992)

[14] The per-capita income growth rates of Argentina and Chile during 1940-1980 were 1 5 and 1.75 per cent respectively.

[15] Data on investment rates can be found in Elías, V. (1992) Evidently the inefficient allocation of resources induced by the trade policy reduced the economic growth rate, and as a consequence available

Moreover, the import substitution policy required the build-up of industrial infrastructure, especially energy and steel, and given the circumstances of the time, this was generally financed and carried-out by the Public Sector. The resources to develop this sector, as well as those necessary to finance social programs to ameliorate the increase in poverty associated to the lower growth rates brought about by protectionism, could often not be raised through taxation The alternative became inflationary finance, which in most Latin-American countries reached, at one time or another, extremely high rates. For example, in Argentina the rate of inflation reached 3000 per cent in 1989 and in Chile it became 609 per cent in 1973[16].

Protectionism and inflation fostered highly discretionary government interventions in the economy In his writings Prebisch had suggested that the criteria for protection should be the capacity of an industry to eventually export, but he also stressed the foreign exchange savings capacity of import substitution Since in Latin America the exchange rate policy tended to be used to control inflation, it is not surprising that exchange shortages were the norm, and that therefore the required protection was granted whenever an industry argued it could substitute imports to save exchange for the country. The emerging arbitrary protective structure, plus other discriminatory measures taken by governments to control the manifestations of the inflationary pressures, generated eventually very inefficient resource allocation incentives

But this was not the only problem As a result of the willingness of governments to intervene in a discriminatory fashion to support certain import substitution activities or to mitigate some of the visible effects of their inflationary government financing, ***rent seeking*** became a more profitable activity than the production of goods and services[17]. Entrepreneurs could earn more by lobbying in favor of higher tariffs or prices than by devoting the same effort to try to increase productive efficiency People moved to the capital cities, creating the mega-cities which characterize practically all capitals in Latin

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savings Moreover, in some countries, notably Chile and Uruguay, lower growth generated pressures to increase government transfers to the poorer, which also had a negative effect on savings (See Lüders, R. (1988))

[16] Rates of inflation in Latin America are much higher than those in other regions. See The World Bank (1989)

[17] Borner, S, Brunetti, A, Weder, B (1992), attribute this process to the lack of true political participation of the population, which allows governments to dictate norms without consultation to anybody.

America, with all the terrible urban problems associated with the trend, since there they could participate in the rent seeking process more easily.

Protection of course is only needed by the weaker. In most of Latin America this is equivalent to saying that the industrial activities were protected, to be more precise, the capital intensive industrial activities were favored. This implied that scarce capital was used-up to a large extend in these activities, and therefore unskilled labor was pushed either into unemployment (and the informal sector) or into the low wage paying service sector, which taken as a whole, is the least capital and skilled labor intensive sector in the region. This generated large pockets of poverty. Moreover, governments, as a result of the already described rent seeking process, often granted unnecessary legal protection to some formal activities[18]. These privileges more often than not resulted in a few people getting very rich without, from an economic point of view, deserving it

The overall outcome has been one of relatively slow income growth, unequal distribution of income and large pockets of poverty During the 1970s the petro-dollar recycling process was able to mitigate some the least desirable consequences of the chosen model and reduce pressures for change. In fact, most Latin-American countries were able to spend significantly more than the income generated, resources which as a rule were used by governments to satisfy rent seekers[19]. Once the debt crisis of the early 1980s broke out, the drawbacks of the import substitution model became evident, and the demand for change universal.

ECONOMIC GEOGRAPHY

Before presenting the structural adjustment programs of Chile during the 1970s, before the debt crisis broke out, and Argentina during the late 1980s and early 1990s, well after the same event, the reader might wish to inform himself of some of the main characteristics of these economies today The data is presented in Table Nº 2.

Argentina has a larger economy, mainly because its population more than doubles that of Chile and in spite of the fact that the latter now has a somewhat higher GDP per capita ,

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[18] See de Soto, H (1989).

[19] The exception is Chile, where the Private Sector incurred in very significant excess spending, while the Public Sector had a superavit

Table No. 2: Basic Economic Information*

	Argentina	Chile
Population (i)		
Stock	33 Million	14 Million
Average annual growth rate 1990-1992	1.2%	1.6%
GDP per capita		
based on nominal exchange rates (ii)	US $4600	US $2900
based on PPC** (1991 data) (iii)	US $5120	US $7060
Average annual growth rate (1991-1993) (iv)	6.3%	6.1%
Manufacturing/GDP (ii)	30%	18%
Central Government*** Expenditures /GDP (i)	19%	25%
Exports/GDP (i)	9%	33%
Main Exports (ii)		
Agriculture	34%	13%
Manufacturing	47%	39%
Minerals	2% (Oil)	48% (Copper)
Other	17%	-
Tariff Range	0 - 22 % (v)	11 % even (vi)
Current Account Balance (i)	-8.6 billion US$	-0.583 billion US$
External Debt / GDP (i)	41%	41%
Debt Service ratio (i)	42%	21%
1992 change in average CPI (i)	23%	15%
1992 change in average WPI (vii)	6%	12%
Fiscal Budget Surplus / GDP (i)	-0.3%	2.7%

* Data are for 1992 unless otherwise indicated

** Purchasing Power of Currencies (PPC)

*** Does not include expenditures at the State level

Sources: (i) Inter-American Development Bank (1993),(ii) Calculated using National Accounts data; (iii) The World Bank(1993); (iv) Using own estimates for 1993 growth , (v) Newfarmer, R. (1992); (vi) Rosende, F (1992); (vii) National Statistics Offices of Argentina and Chile

US$ 7060 in contrast with Argentina's US$ 5120, if measured on a Purchasing Power Parity basis[20]. Argentina has a much more developed manufacturing sector, 30 percent of GDP versus 18 percent, and Public Sector spending[21]is very high in both countries compared with most other Latin-American economies. From another perspective, Chile's economy is today significantly more open to international trade than Argentina's.

Mineral exports, mainly copper, still comprise 48 per cent of Chile's US$ 10 billion exports, which in turn amount to 33 per cent of GDP Manufacturing, mainly processed raw materials and foodstuffs[22], with 39 per cent of exports and agriculture products, mainly fruits and some silvi-cultural products, make up the difference Argentina, which only exports 9 per cent of GDP, has a diversified manufacturing export basis, and is, as is well known, a significant grain and meat exporter.

Although both countries have about the same weighted average custom duty, Chile has today *an even 11 per cent duty on each one and all imports and practically no other import restrictions of any kind* Since it also uses a drawback to compensate non-traditional exports (all exports but copper, fishmeal, paper pulp and paper), the resulting incentive structure is uniquely uniform, not only among developing countries, but universally. Argentina's imports are subject today to a 0-22 per cent range of duties, some additional differentiated taxes and some other restrictions, resulting in significantly more differentiated effective protection rates

Both countries are still heavily indebted abroad. Argentina has a debt to GDP ratio of 41 per cent, and a debt service ratio of 42 per cent, while the corresponding rates for Chile are 41 and 21 per cent. Although Argentina's foreign indebtedness burden is significantly higher, so are the estimated financial investments of its citizens abroad.

Argentina pegged in 1991 its currency to the dollar by law, while Chile has been using a crawling peg exchange rate system. Chile enjoys a significant budget surplus and Argentina has a very small deficit, reflecting the considerable priority attached to fiscal

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[20] Measured using the current exchange rate as the basis, Argentina's GDP per capita was during 1992 US$ 4600 while that of Chile was US$ 2900 This measure reflects in part the overvaluation of the Argentine currency

[21] Central Government expenditures were in 1992 nineteen percent of GDP in Argentina, and 25 per cent in Chile If to these percentages Provincial Government expenditures in Argentina are added, which are significant, and also value added by the SOE sector in both countries, Public Sector can be estimated to reach around 40 per cent of GDP in both countries, which is high for developing countries with market economies

[22] Paper, paper pulp, fishmeal and molybdenum are the most outstanding

discipline. The macro-economic policies adopted in both countries recently have resulted in *Current Account deficits*, which are very significant in the case of Argentina but compensated by capital inflows, and in *relatively low rates of inflation*, especially in Argentina if measured by the Wholesale Price Index (see Table Nº 2).

In both countries these relatively low rates of inflation have been accompanied by relatively high income growth rates and low unemployment rates. In fact, the average GDP per capita growth rate for the 1991 1993 period has been 6.3 per cent in the case of Argentina and 6.1 per cent in the case of Chile[23]. Unemployment rates have been 6.6 and 5.3 per cent respectively

This relatively satisfactory state of economic affairs in both countries is perhaps best reflected in the political process In Chile, after the long government of President Pinochet under whose leadership the structural reform process took place, Patricio Aylwin, elected in late 1989 with the support of a coalition of Christian Democrats and Socialists, introduced only minor changes into the existing economic development model In Argentina, President Menem, elected in 1989 with the main support of the Peronists, implemented the structural reform program in spite of a very different and traditional electoral platform, and then won easily in October of 1993 the Parliamentary elections for his party He is now seeking a Constitutional reform to allow his reelection.

ECONOMIC REFORMS IN CHILE DURING THE 1970S and EARLY 1980s

The first country to engage in a large scale structural reform in Latin America during the last two decades, and the one whose reforms have been deepest up to now, was Chile. This is not surprising, since it was also the country where the import substitution process had been carried the farthest, and thereby had contributed most significantly to generate the very deep socio-political and economic crisis of 1973 During that year GDP dropped by 5.6 per cent and the inflation rate, as measured by the Consumer Price Index, rose to 609 per cent Change became inevitable.

[23] 1993 estimated.

The search for a more appropriate development model

Economic growth performance in Chile, after the adoption of the import substitution model during the late 1930s, was well below the average for the region and the developing countries in general[24]. Income distribution was worsening and inflation was rising. There was general disappointment with the performance of the economy, and people were searching for alternatives.

Three of these emerged The *Conservatives* proposed to maintain the import substitution model as far as trade policies are concerned, but to reduce government intervention in other areas The *Christian Democrats* favored reduction in the degree of protection, but stressed structural reforms in land holdings and taxes, among other sectors Finally the *Socialists and Communists* believed that only a centralized economy could solve the development problems of the country

During three successive governments, all democratically elected[25], each of these groups had a *chance* to implement their desired model Neither the Conservatives nor the Christian Democrats succeeded in the short run, the first two to three years, to implement but a few of the desired changes and thereafter, having lost support in Parliament to continue reform, they limited their task to administer the economy with the existing structure.

The Marxists tried to speed up the revolutionary reform process, expropriating most of the remaining irrigated land in hands of the Private Sector, purchasing absolute control in all financial institutions and gaining control of about 500 industries and commercial firms, the largest in the country. In addition they fixed almost all prices in the economy, and transformed international trade into a State Monopoly. The economic results of this centralization process were a disaster, and in the process of reform they did not respect some Constitutional rules, which led Parliament, after the Supreme Court had confirmed the violations, to invite the military to take over. The military intervention was supported by the Christian Democrats, other political parties of the center and the political right. The

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24 See Lüders, R (1988) for data supporting the assertions of this sub-section and additional references.

25 Although only Eduardo Frei, the Christian Democrat, received an absolute majority and was accompanied by a Parliament also dominated by his party. At the other extreme, Salvador Allende, the Socialist, barely got 34 per cent of the vote in a three way, very close race. He was confirmed in Parliament, according to the Constitution of the time, with the support of the Christian Democrats. These demanded from Allende certain guarantees, which he later on did not respect

Military government enjoyed an initial 80 per cent popular support, according to polls taken at the time.

The Chicago Boys and the market economy

It took the military about a year to decide to implement a market economy as the alternative to the import substitution model with heavy government intervention existing up to 1970. At some time, during 1974 and under pressure from a small minority of Nationalists, they considered to continue with protectionism, significant regulation and heavy government control of large industries, especially those related to National Security and other military purposes. The lack of political support, as well as the financial difficulties envisaged for 1975, induced the Pinochet regime to implement an economic program designed by a small group of economists, informally representing all opposition groups to Allende including the Christian Democrats, and most of them trained at The University of Chicago[26] This program, which favored a market economy for a developing country, a novelty at the time in Latin America[27], had been prepared by these economists as a contribution to whichever government would follow the Allende Regime

Once Pinochet opted for the proposed model, he invited the "Chicago Boys" to lead the economic restructuring. The name of "Chicago Boy" was in fact used for those economists which designed the program, plus many others who worked for the Military and had received up to date Ph.D. level training at first rate schools of economics in the U.S A. or other developed countries, or at schools like that of the Pontifical Catholic University of Chile which had developed its faculty as the result of a relatively long, A I D. sponsored exchange program with The University of Chicago

The program was, as shall be seen, revolutionary, and initially was opposed by large segments of the population, in spite of its success in accelerating the economic growth rate during the second half of the 1970s. The authoritarian character of the Military Regime and the support of the business leadership, however, allowed Pinochet to stay on course, even

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[26] This program, up until recently only in the form of an unpublished memo, was published as El Ladrillo (de Castro, S (1992))

[27] After the 1930s, economists in general would argue, initially, that market economies only worked in developed countries, and later, when some of the Asian economies industrialized as market economies, that some cultural traits of the Asians, like being hardworking and thrifty by nature, made the difference. The Chicago Boys, instead, believed that institutions and economic policies which provided incentives for economic agents to work, save and allocate resources appropriately, contributed most to economic growth, almost irrespective of their stage in development and their cultural background

after the extremely severe recession of 1982-1983, which forced him to accept some transitory, but only "tactical", concessions during 1984[28] Thereafter, the transitory measures were reversed, and the economy entered into a long period of rapid growth and relatively low inflation rates, which lasts until today.

The Chilean economic development model

The economic development model implemented in Chile is of the often called "social market" variety It is, above all, a *competitive market economy* in which economic growth is to be *led by the Private Sector and by exports* The State, besides providing directly or indirectly public goods, only regulates economic activity in those cases in which obvious net social welfare gains can be expected, and takes steps to equalize opportunities among citizen through the financing of health, housing, education and a (small) of the part Social Security expenditures The next paragraphs develop some of the main principle implicit in the above definition

Trade policy in the Chilean model follows the *comparative advantage* principle instead of the import substitution doctrine Since the Chicago Boys believed that Chile had little monopoly power, even in the supply of copper, and no monopsony power whatsoever, *free trade* became the goal This trade policy was to be complemented with free internal trade, that is *no price controls* except for the rare existing service monopolies The emphasis on exports has its origin in the small size of the Chilean economy, which makes it almost unavoidable, given present production techniques, to trade a high proportion of production to be efficient.

As far as the role of the State is concerned, it is *subsidiary,* impersonal and non-discriminatory Subsidiary actions are defined as those which the Private Sector is not willing or able to carry out, and which nevertheless are necessary to achieve the common good or maximum social welfare This principle, like many others, does not provide a specific measure to solve each problem, but nevertheless instructs, on the one hand, the policy maker clearly to limit regulations and other interventions to those cases in which

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28 These concessions were made mainly to gain the lost support of the business leadership The most significant was a raise in the custom duty level from 10 per cent even, the level it had reached in 1979 under the leadership of Sergio de Castro as Minister of Finance, to 35 per cent, the maximum level possible under Gatt rules In 1975, however, Pinochet replaced his non Chicago Boy Finance Minister Luis Escobar Cerda for another "Chicago Boy", Hernán Büchi, who lowered duties to 15 per cent even, in the course of a few years The final reduction, to 11 per cent even , was institutionalized by Minister of Finance Alejandro Foxley in 1991, under the presidency of Aylwin

market failures are evident and the government intervention is less costly than the consequences of the failure. On the other hand, this principle is consistent with government *provision of public goods and social services* which characterize social market economies.

The *impersonal* role of the State was adopted to avoid unfair discrimination among citizen, as well as to prevent rent seeking and corruption. This norm has to be considered together with the principle of *non-discrimination*, the main objective of which is to avoid privileged treatment to some sectors or products in relation to others, and whose effective implementation requires the State to assure *free access and exit* to all those interested in joining or leaving markets in such a way as to preclude the legal monopolization of markets

A final characteristic of the Chilean model, although not very original, is the high priority assigned to *fiscal and monetary discipline* In fact, this discipline is considered a necessary condition for a reasonable allocation of resources, without which a rapid rate of growth can hardly take place

The above principles guided the structural reform process and the economic policies during the Military Regime, and continue today guiding those in charge of economic policy. The main reforms implemented up to now are listed below, while a description of a few of their most outstanding features is presented thereafter

A very brief description of the main structural reforms during the 1974-1981 period

In this sub-section the main structural reforms carried out in Chile during the Military Government are classified into nine main categories.

To *liberalize trade*, practically all quantitative restrictions and exemptions were eliminated, tariff rates were unified and reduced to the current 11 per cent even, Gatt rules are strictly respected and also in those few cases in which compensatory tariffs have been imposed, and a drawback has been implemented for non-traditional exports, to reduce discrimination against tradables to the minimum possible.

The *exchange rate r me* was radically changed. For this purpose, the exchange rate for imports and exports was unified, and a "Crawling Peg" system was institutionalized. This system uses today a basket of currencies as its reference point, instead of the U.S.A. dollar, as during the Military Regime

The *fiscal reform* was also deep, both to balance the budget, as well as to reduce the efficiency costs of taxation. Expenditures were drastically reduced and prices of Public Sector provided goods and services increased to cover costs. The sales tax was replaced by an value added tax, and the income tax was reformed to introduce features which resemble a progressive expenditure tax. Preferential treatments were eliminated completely and monetary correction was introduced into accounting and tax reporting. Considerable decentralization of Public Sector activities was accomplished.

Management of State Owned Enterprises (SOEs) was rationalized. Equal treatment for SOEs and private firms was granted, all privileges of SOEs were eliminated, SOEs became subject to a 100 per cent of profit dividend policy and self-financing, new investments had to follow the procedures of the National Project Evaluation System to be approved, and about 500 SOEs were privatized, in the up to now relatively largest SOE divestiture process of the West

The *stabilization policy* was based on the reduction/elimination of the fiscal deficit, on stricter control of fiscal expenditures, and on the prohibition of Central Bank lending to the Government. Late during the Military Regime the Central Bank became independent from Government.

The *Capital Market was also significantly liberalized.* To this end, all credit controls and special credit lines were eliminated to let the market allocate credit freely, interest rate ceilings were also eliminated, foreign capital flows were almost completely liberalized, multi-purpose banking was institutionalized, and barriers to new local banks eased. Prudential regulation was adopted in 1981, after the experiment of a system with little regulation and an implicit guarantee had generated some excesses

Price controls were completely eliminated over a three year period, as were most subsidies. Perhaps the only significant subsidy left is that to forestation Anti-monopoly legislation was dictated and is being enforced.

The *labor market was also reformed* A new labor code was dictated, according to which collective bargaining is carried out at the firm level and workers are free to join one or more unions The system works in such a form that whenever unemployment exists wage readjustments will tend to be modest, if at all, to privilege employment, while at full employment wages will tend to increase, reflecting demand. To diminish wage costs, severance payment benefits were reduced, as were other privileges However, a minimum wage is still being fixed

Some of the most interesting reforms took place in the Social Security area Contribution rates were significantly reduced by extending retirement age to a uniform 65 years for men and 60 years for woman Special discriminatory benefits were almost totally eliminated. The Pay-as-you-go system was replaced by an Individual Capitalization system, in which the Pension Funds are privately managed, although highly regulated

Finally, a *new foreign investment statute* to equalize treatment of national and international investors was adopted This statute flexibilized significantly the rules for capital and profit repatriation In addition the possibility of debt/equity swaps was offered, and it became a mayor factor in the relative reduction of Chile's foreign debt

Structural reform and economic policy highlights 1974-1989

In this sub-section some of those most interesting aspects of the present Chilean economic structure will be highlighted and described in more detail. For this purpose the following have been selected: the relatively low and even tariffs; the almost complete market liberalization; the National Social Project Evaluation System, the privatizations; and the emphasis on social expenditures and the modernizations in that sector.

<u>The even tariff structure</u>

During the 1974-1979 period Chile lowered its highest tariffs, which had reached 200 per cent[29], to 10 per cent, and raised to the same 10 per cent level all tariffs which at the time were lower. Simultaneously, all quantitative restrictions and previous deposits were eliminated Moreover, a drawback of up to 10 per cent is today granted to all non-traditional exports.

[29] In addition to a deposit of 10,000 per cent in some cases, to be made at the time authorization to import was granted and to last at least 90 days or until the merchandise was brought into the country.

The emerging effective protection structure is *almost perfectly non-discriminatory*[30]. It is a well known fact that differential custom duties widen the spectrum of protection. Often, and Latin America certainly conformed to this pattern after having adopted the import substitution strategy, tariffs tend to be high for finished "luxury" consumption goods and low, or non-existent, for "necessities" and inputs This usually implies extremely high effective protection rates for "luxury" finished products and negative effective protection rates for "necessities" and exports. These negative rates come about because producers pay duties on some of their inputs, but have to compete with products produced abroad whose producers are not subject to the same burden[31]. The resulting production structure is exactly the opposite from the desired: countries produce more "luxury" goods than optimum, and less "necessities" and goods for exports Since the "necessities" are cheap, they have to be imported to satisfy demand, causing balance of trade problems. By adopting a relatively low uniform tariff as a result of the tariff reform, together with a drawback, Chile achieved an almost perfectly even protection rate[32], *getting rid of the existing anti-export bias* and allowing producers to make use of the countries comparative advantage This, together with free prices, contributed perhaps more than anything else to the improvement of Chile's allocation of resources.

Another important advantage of the uniform tariff is that rent seeking through customs is practically impossible Any special tariff for a certain sector or to favor a specific group would immediately be detected by everybody In fact the system is so powerful, that any sector seeking protection (for example industry) will face the immediate opposition of the remaining sectors (agriculture, mining), which "pay" the protection through a lower real exchange rate At least this is what happened in Chile during the mid 1980s, when in the process of lowering tariffs back from 35 per cent even to 11 per cent even, the industrial sector asked for differentiated tariffs, which agriculture and mining opposed vehemently and successfully In fact, the advantages of low and uniform tariffs have become so clear to policy makers in Chile, that when the Minister of Finance asked Congress to lower tariffs from 15 to 11 per cent even in 1991 , his proposal was approved within 48 hours

30 Effective protection is defined as the ratio between (Value Added Internationally less Value Added Locally) and Value Added Internationally

31 In Chile during 1970 products like radios and washing machines had effective protection rates exceeding 80 per cent, while certain agricultural products like wine and wheat, today being exported, faced negative protection rates of 50 per cent and higher (see de la Cuadra, S. (1974)). On average, in 1974, before the sharp reduction in protection took place, the mining and agricultural sectors, potential exporters, faced negative effective protection rates of 32 and 21 per cent respectively (see Aedo, C. and Lagos, F. (1984)).

32 The exceptions are traditional exports, which are discriminated against, and some argue, a very few products which receive anti-dumping protection following the Gatt rules.

with only one abstention Moreover, with an even tariff it is relatively easy for the Finance Minister to reject demands by certain industries for special protection

To complement the just described trade policy, and as another example of the application of the principle of non-discrimination, Chile is treating in every respect foreign direct investment almost exactly like local capital, and has increasingly liberalized foreign exchange operations to the point that, today for all practic . purposes, no restrictions exist to international financial flows in any direction

The market liberalization

As mentioned, Chile adopted, above all, a competitive market economy. The trade liberalization just described, carried out during the 1970s, was one of the most important reforms in that direction, since it introduced competition into an otherwise rather small market In addition, prices and interest rates were freed quite early in the period, during 1973-1974 and 1975 respectively[33] Moreover, during the 1970s hundreds of regulations limiting access to different markets were gradually eliminated, and the formalities to establish a new business or industry were drastically simplified

The labor market was also made more flexible During the 1970s collective bargaining was suspended, but in 1979 new labor legislation was approved This legislation following rather closely the one adopted in the U S A and allowed strikes and lock-outs in such a manner that under labor scarce conditions, increases in wages were favored, while during labor abundant periods, additional employment was privileged A minimum salary still exists, which nevertheless has been fixed at a low enough level to avoid any mayor effect on employment The Aylwin government introduced some amendments to this legislation, but these, while strengthening the bargaining position of the workers vis-a-vis the entrepreneurs, did not affect the basic characteristics of the same.

However, in spite of this important market liberalization, anti-monopoly legislation exists and is actively used, while the prices of a few services, judged to be natural monopolies, are fixed by law These latter include those of electricity distribution and transmission. The local telephone service has also a fixed price, but only as a result of a decision of the Anti-monopoly Commission, since telephone prices are, in principle, also free.

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33 At the same time credit ceilings as well as all other quantitative credit restrictions were eliminated.

The privatizations

To transform the Private Sector into the main engine of growth, private property rights, which had been weakened during the Frei and Allende administrations, were Constitutionally strengthened, especially by allowing State expropriations only for the "common good" and with cash payment at market prices, giving the proprietor the right to appeal the decision and the price to the judicial system[34]

In addition, about 500 State Owned Enterprises and about half the irrigated land in the country were privatized[35] Most of the privatizations took place between 1974 and 1978, when those enterprises and the land added to the Public Sector between 1964 and 1973 were divested During the Second Round of privatizations, the large traditional State Owned Enterprises, many of them public services like electricity and telecommunications, were sold. In addition, during this latter Round about 50 of the largest enterprises divested during the First Round, which had fallen into Public Sector hands during the strong recession of 1982-1983, were re-privatized. As a result, during this Second Round a higher value of assets was transferred to the Private Sector than during the First Round. These privatizations taken as a whole still constitute the largest privatization program in the West, and effectively put economic power in the hands of the Private Sector, but in a relatively widely spread way.

Moreover, due to the privatization modes used during the Second Round, especially *"labor capitalism"*, that is, shares sold at subsidized prices to workers, *"popular capitalism"*, that is, shares transferred free of charge to income tax payers but in small packages, and *"institutional capitalism"*, that is, shares sold to insurance companies, the newly created private Pension Funds and other institutional investors, privatization dispersed economic power significantly Especially workers, directly through labor capitalism and indirectly through their participation in the Pension Funds, gained control of the Boards of some of the largest enterprises in the country. Moreover, they have been wise enough to name as their representatives well prepared business managers, and they have not lost out of sight that the way to maximize their own benefit is to assure that these enterprises in turn maximize profits

[34] Recently the owner of a house blocked one way of a practically finished freeway for years, just because he would not agree to the price being offered for his property by the Government.
[35] For a full description of the process and its effects see Hachette, D. and Lüders, R. (1992).

The National Social Project Evaluation System

In spite of the above privatizations, the Public Sector, as was pointed out above, is still very significant in Chile. Besides investments in Public Works, at local, regional and national levels and the Social Sectors, the State still has to decide on investment in enterprises it owns These comprise about 40 firms, among them CODELCO, a huge copper mine, Colbún-Machicura, one of the largest hydro-electric generating plants in the country, most of the water and sewerage companies, etc

Traditionally these investments reflected to a large extend political and interest group pressures, instead of expected returns to society. To maximize the social benefit derived from Public Sector investment, the Military Government developed the National Project Evaluation System.

According to this system each project has to be evaluated by the originating office or enterprise, according to norms which reflect up-to-date social project evaluation techniques, and using "social" prices determined each year by the Ministry of Planning[36]. The same Ministry fixes each year a cut-off minimum rate of return: projects which exceed this rate can be carried out *if* the office or enterprise has the necessary financial resources, while the remaining projects are rejected, *even* if financing is available The cut-off rate reflects, of course, marginal rates of return within the Private Sector, so as to maximize the returns from investment in the country.

Small projects, once evaluated at the originating office or project, can be carried out immediately, given available financing. Larger projects have to be submitted for project evaluation control and approval to the Ministry of Planning If accepted, but no financing is available, financing might be requested to the Budget office during the next budget year.

As a result of this process, at any given moment, different Public Sector offices and enterprises have a pool of projects available, which are carried out reflecting preferences of local, regional or national institutions and enterprises, but always making sure they return to society at east as much as the marginal Private Sector investment projects. Although according to the law the President could decide to implement a project which has a rate of return which is below the cut-off rate suggested by the Ministry of Planning, this has not

[36] Social prices are the equivalent of shadow prices, that is those prices that would prevail in the absence of economic distortions, and in Chile are fixed on the basis of studies contracted out to academic institutions

occurred. As in the case of the 11 per cent even tariff rate, braking such an "objective" rule as the one described here, requires a very good public explanation from the authority.

The focalization of social expenditures and the modernizations in that sector

Chile introduced Social Security in the early 1920s, and ever since has emphasized social expenditures. education, health and housing. During the 1970s social expenditures in Chile relative to GDP reached levels similar to those in the OECD countries, which were several times as high as those prevalent in most Latin-American or Asian countries[37]. However, as in most countries of the region, these expenditures, if Public Sector financed, tended to benefit the middle class, rather than those most needy.

The Military Regime, on the basis of poverty surveys, *focalized its social expenditures* on the poor[38]. In this way, it was able to reduce dramatically infant mortality rates and sub-standard housing conditions, and in general, *raise social indicators to those of the developed countries* This is perhaps one, if not the, most important achievement of the Military Regime, which in addition has significant implications for the future development of the country.

The "modernizations" carried out during the military government contributed to the efficiency of the social expenditures of the country. These can be defined, in general, as the *separation of the regulatory, financial and production functions* of the social sectors. Regulation then becomes the basic government responsibility, financing is private except in those cases of the poor where the government plays a subsidiary role, and production is carried out by the private sector on a competitive basis The application of these principles to pensions, most of education and some part of the health programs, which in practice can hardly be found in any country although many academicians have advocated them, can be considered another mayor accomplishment of the Military Regime.

The Chilean pension system is perhaps the best example of the application of these principles In the past, workers and employees contributed to Pay-as-you-go pension institutions. Many of these existed, depending on the activity carried out by the employee, and most of them run important deficits financed through the Central Government budget. Contribution rates and benefits varied from one institution to another, the "rate of

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[37] See Lüders, R. (1988).
[38] See Castañeda, T (1992)

exchange" between contribution and benefits varying according to the political power of each group. It is no surprise that congressmen were able to retire on a full pension after only one term in Congress. Constant political pressures, hard to resist at election times, existed from pensioners or workers about to pension, to increase these, or to reduce retirement age, at the expense of the government budget. The system was of course broke, like it is in many countries, when the Military Regime took over

To put the system on a sound financial basis, the Military Government leveled contribution rates and benefits for all Social Security institutions, except, not surprisingly, the military. It also fixed the minimum retirement age at 65 years for men and 60 years for women[39], which allowed it to reduce average contribution rates very significantly[40] Finally, to rationalize pressures for additional benefits, it obliged workers to pay 100 per cent of the Social Security taxes, while at the same salaries were raised in the amount of the employers contributions, leaving net of taxes salaries unaltered It then created, among other reforms, a new privately run pension system which existing workers could join if they so wished, and new workers had to join after the system had five years of existence

According to the new system each worker has to put his pension fund contributions (10 per cent of salaries or similar amounts in the case of independent workers) into the Pension Fund of his choice[41] Each Fund is managed by a private Pension Fund Administrator (AFP), who is competing with the other managers on the basis of the level of the management fees, the returns to the Funds they are able to obtain and the quality of service Workers can switch freely their accumulated funds from one Fund to another, to encourage the competitive process At retirement time, each worker gets his accumulated fund (contributions plus returns), which allows him to either buy a lifetime pension at a life insurance company, or to deposit it at any one of the Pension Funds and draw a yearly "programmed" retirement income[42]. Contributions are tax free, but pensions and retirement incomes are taxable for income tax purposes.

Given that workers are forced to make contributions, the system is subject to an implicit State responsibility That is why it is highly regulated, especially with respect to the

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[39] The rationality of this discrimination, common all over Latin America, is also doubtful, especially considering that women have a significantly longer life expectancy than men

[40] Social Security contributions, as a percentage of gross salary, are today about 17 per cent.

[41] Today there are 21 of these Funds

[42] The worker will gain with pension if he lives longer than normal, while he will benefit his heirs, and enjoy at the same time a higher retirement income if he lives shorter than normal

investment portfolio. A special institution was created to supervise the Pension System (Superintendencia de Fondos de Pensión), whose head is Government appointed. There are legally established relative maximum amounts the Pension Funds can have invested in any one *type* of investments, like Public Sector papers, commercial bank deposits, shares in the capital of firms, foreign investments, etc. Moreover, there are limits to the share in any firm any single Pension Fund can have, as there are limits to the proportion of the Fund invested in shares of any one enterprise. Finally, these investments, except in Public Sector papers, have to be graded by private firms, and each Fund has to comply with an relatively high average grade

The Pension System has worked well in practice. Service to employees and retired persons is excellent, and the system has been extremely profitable Its operational costs, in line with the quality of the service, is however relatively expensive. Today the accumulated funds exceed 30 per cent of GDP, and have become a major force in the Chilean Capital Market. The Pension Funds are professionally managed and very competitive, and have therefore contributed to make the whole system more competitive and transparent. The accumulation of these Funds is now making possible the strong foreign investment of Chilean firms in Argentina, Peru and many other countries, since thse funds capitalize the Chilean investors firms to a large extent There is, of course, no miracle behind this. The Public Sector had to make, and still is making, a significant effort to finance the pensions of those who retired before this system came into being. This is requiring an estimated Government surplus of 3 to 4 per cent of GDP [43].

Some of the main structural reforms of the Chilean economy have been described above. Others follow the same lines, making use of market forces wherever possible, and using regulation to improve the operations of markets or to avoid excesses in the few remaining natural monopolies. The results, in terms of growth, have been satisfactory enough to allow the country, for the first time in many decades, to reach an agreement about the basic characteristics of its desired growth model. In the following section the response to the debt crisis of an open to international trade market model like the Chilean or those used in some of the more dynamic Asian economies, is compared with that of the representative Latin American economy of the 1970s, following the import substitution strategy.

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[43] See Diamond, P. amd Valdés-Prieto, S. (1993). In 1987 the transition deficit reached 4.8 % of GDP.

THE EFFECTS OF THE DEBT CRISIS OF THE 1980s ON THE LATIN-AMERICAN DEVELOPMENT STRATEGY

For Latin America the economic growth performance of the 1970s was relatively positive. For the region as a whole, GDP per capita grew at a rate of 3 3 per cent per year. The expenditure rate grew even faster, as the result of a significant increase in foreign indebtedness made possible by the petro-dollar recycling, creating a general sense of well-being. In hindsight, the decade of the 1970s should have been one of general economic restructuring, since the benefits of the import substitution model, if any, in allowing the beginning of an industrialization process, had been exhausted Instead, indebtedness delayed a necessary process, making it even more costly thereafter In this sense, for Latin America the lost decade was really that of the 1970s, when change should have taken place, and not that of the 1980s as usually considered Only Chile, as a reaction to its unique socio-economic and political crisis of the early 1970s, deregulated its economy as described in the previous section, and, as suggested by Table Nº 2, was therefore able to recover from the recession of the 1980s significantly faster than the rest of the region

The foreign debt crisis of the 1980s and its consequences

As can be seen in Table Nº 3, especially during the late 1970s and the beginning of the 1980s, most of the countries in Latin America increased their foreign indebtedness levels very fast When these had reached very high levels as measured by

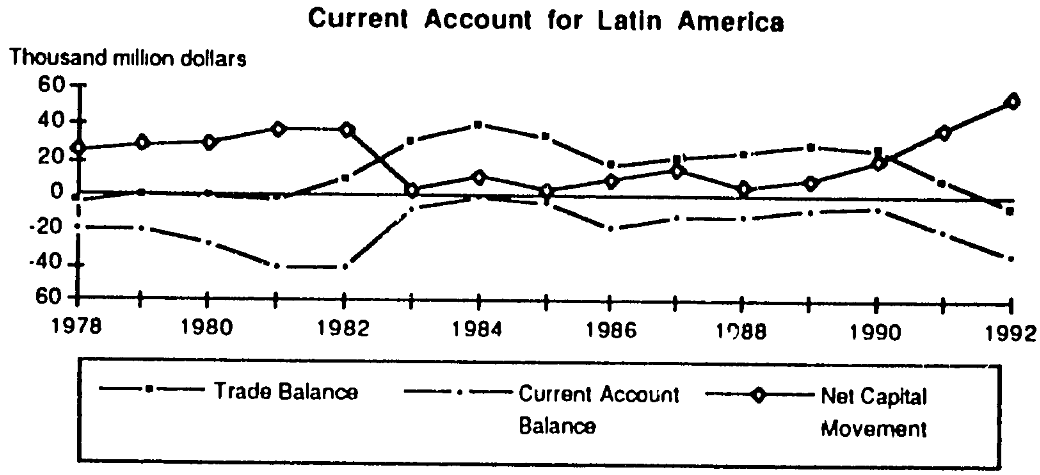
Table Nº 3: External Debt Indicators

Year	External Debt Millions of Dollars	External Debt as % of Exports of Goods and Services		
	Latin America	Latin America	Chile	Argentina
1980	222,497	222	188	275
1982	330,962	326	370	475
1984	365,809	329	456	481
1986	401,011	427	396	610
1987	428,066	398	327	717
1988	420,906	341	229	525
1990	440,948	290	180	412
1992	450,875	282	150	382

Source: CEPAL (various years), "Balance Preliminar de la Economía de América Latina y el Caribe"

the usual standards of the commercial banks, the new spontaneous foreign capital flow into the region was suddenly cut off in 1981. This happened while international interest rates rose sharply and simulataneously the terms of trade moved against most of the countries in the region, as the result of an international recession generated precisely by the adjustment process of the developed countries to the increase in petroleum prices. As a result of the cut-off in new lending, most countries not only had to limit expenditures to their own income, but were forced to go beyond that, and serve their debt by reducing expenditure levels below income. This drastic change can best be appreciated in Graph Nº 1, which shows the evolution of the current account deficit of the region, which moved suddenly from an extremely high balance to almost zero.

Graph Nº 1: Evolution of the Current Account for Latin America



The negative growth effect of the debt crisis

A problem created by a high negative current account balance which has to be reduced because of a capital inflow restriction, can be solved by either increasing exports or by reducing imports, or by some mix of both policies. Faced with the same consequences of the international recession of the late 1970s and early 1980s, the Asian "tigers" basically decided to expand exports, and were successful in that endeavor while at the same time output continued to expand, because they had adopted an economic development model which had induced entrepreneurs to produce efficiently[44] Latin America, with the exception of Chile, tried to follow the same strategy, but failed, basically because of the consequences of the adopted import-substitution development policy on the efficiency of its productive sectors.

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[44] See Harberger, A C. (1985).

In fact, the first reaction to the debt crisis in Latin America was to try to increase its exports However, as a rule, the region was only able to compete in the raw material and foodstuffs markets, since in the production of the remaining goods it was inefficient due to the traditional protection granted under the import-substitution framework. Unfortunately, in large part, due to the inelasticity of demand for raw materials and foodstuffs, and the presence of recessionary conditions in the international markets, the increase in export *quantities* only generated a reduction in the regions export prices, and a fall in the terms of trade, but no increase in the export *values*

The solution therefore had to be sought in the *reduction of imports* Since the same import-substitution model had induced the internal inefficient production of final industrial (consumption) goods, the import structure of most countries in the region was heavily weighted towards necessary inputs (machinery and equipment, parts and components, some specific raw materials not produced) and in some cases essential foodstuffs (wheat, meat, etc.). This implied, that the reduction of imports had to affect either the *output levels* of the country or the basic food consumption levels of the population, or both, as in fact happened As one pertinent example, Table Nº 4 shows the data of the case of Argentina, and compares it with Chile, which already had almost completed its structural reform process.

Table Nº 4: Trade Balance and GDP for Chile and Argentina

Year	Trade Balance Millions of Dollars		GDP Millions of 1988 Dollars	
	Chile	Argentina	Chile	Argentina
1980	-764	-1,378	24,650	142,933
1981	-2,677	712	26,337	131,795
1982	63	2,764	23,571	122,083
1984	362	3,982	24,324	128,250
1985	884	4,878	24,765	119,704
1986	1,092	2,446	26,140	128,518
1988	2,219	4,242	29,706	129,291
1990	1,273	8,628	33,258	121,369
1992	749	-1,649	38,925	143,880

Source Inter-American Development Bank (1993), "Progreso Económico y Social en América Latina 1993"

The inflationary effect of the debt crisis

In Latin America, again with the exception of Chile, Governments were the main recipients of the foreign capital inflows of the 1970s and early 1980s. They used these resources to expand social programs, public works programs and consumption expenditures In the case of Chile, in line with the new economic development model implemented during the 1970s, the increase in foreign debt was incurred by the Private Sector[45]. When these capital inflows dried up during 1982, the Latin-American governments were suddenly faced with a government deficit financing problem Having to confront a similar situation, although at a different scale, the Asian "tigers" reduced some expenditures, increased some taxes, and solved it in a non-inflationary way. Unfortunately the governments in Latin America were too weak to do so, and were forced to turn to inflationary finance, generating in the process some of the highest inflation rates known[46].

Governments in Latin America were, and in most instances probably still are, very weak as a result of the existing political institutions[47]. The democratic process, when it is in force, is not very participatory. Governments get elected in general on the basis of the support of relatively small interest groups, and are only able to retain power on the basis of granting favors to these groups and of populist measures This, by the way, is also true for most military regimes Faced with the debt crisis of the 1980s, these governments did not have the degrees of freedom necessary to cut back expenditures or increase taxes, without being thrown out of power. In fact, inflationary finance did not help either During the 1980s in Latin America the overwhelming majority of the political parties in power were replaced, and dictatorships (except that of Fidel Castro) gave way to democracies[48].

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[45] These foreign resources were in part purchased by the Public Sector with its surplus and took the form of a sharp increase in Foreign Reserves at the Central Bank, and the rest was used by the Private Sector to increase its investment and consumption rates

[46] For example, and besides the case of Argentina, in Brazil the inflation rate reached 2938 per cent in 1990 , while in Peru it became 7843 per cent in 1990.

[47] See Borner, S.; Brunetti, A and Weder, B (1992)

[48] It would be interesting to evaluate how much of the fall down of the dictatorships in Latin America during the 1980s can be attributed to the so called "silent diplomacy" initiated by President Reagan, and how much to the described institutional and economic factors

The evolution of the inflation rates in Argentina and Chile shown in Table Nº 5 helps again to illustrate the relationship between the debt crisis, structure of the economy, and in this case, inflation.

Table Nº 5: Inflation in Chile and Argentina

Year	Percentage change in average CPI	
	Chile	Argentina
1980	35 1	100 8
1982	9 9	164 8
1984	20.3	626.7
1985	29.9	672 2
1986	19.0	90 1
1988	14 7	343 0
1989	17 1	3079.1
1990	26.0	2314 1
1992	15 4	24 9

Source Inter-American Development Bank (1993), "Progreso Económico y Social en América Latina 1993"

Debt crisis, negative income growth, inflation and structural adjustment

The disastrous economic and social conditions present in Latin America after the debt crisis erupted, led of course to the search of ways out. Especially after 1985, Chile seemed to be on its way to a relatively high and steady rate of growth on the basis of its brand of a market economy model, but many considered that this "model" required, to be implemented and sustained, the presence of an authoritarian regime, which was not acceptable The extraordinary economic performance of several relatively small Asian economies was another example of internationally open market economies which were growing fast, but, most said, required Asians to make it successful[49]. Bolivia, in 1985, implemented a shock treatment anti-inflationary program, but the liberalization of the economy was relatively modest and the growth rate disappointing It was not until Mexico, under Salinas de Gortari[50], adopted a full fletched internationally open market economy, and privatized a large number of State Owned enterprises, and the international lending institutions, especially the World Bank, recommended a similar structural readjustment program for the rest of the countries of the region, that "the" model became acceptable to most Latin-American leaders

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[49] In Latin America there is a saying for a hardworking person· he works like a Chinese (trabaja como chino)

[50] In fact President de la Madrid initiated the reform process, but it was his successor who embraced them fully, and accelerated its implementation.

At the beginning of the 1990s the rhetoric had changed completely in the region. Protection and State intervention were out, open international trade and financial policies, and a subsidiary role for the State, were in. Socialism and State Capitalism were out, different brands of (Social) Market Capitalism were in[51]. However, relatively few countries besides those mentioned above had made the transition from the old model to the new. Argentina and Peru have made significant progress; Costa Rica, Venezuela, Nicaragua and El Salvador perhaps not as much, but their structural reforms have also been impressive, and most other countries in the region have taken important steps in the direction of liberalizing and privatizing their economies Even Brazil, the only large economy in which rhetoric is still way ahead of actual reforms, has deregulated, liberalized and privatized important sectors of its economy

For most observers and experts in the region, the crisis generated by following the protectionist and interventionists policies too long, has been so deep, that Latin America is now in the midst of an irreversible trend towards more reliance in the market and less State intervention. The deepness of the crisis has been so significant in many countries of the region, that most of the groups benefited by protectionism and other forms of State interventionism expect to gain in absolute terms from the liberalization and privatization policies in the medium and long-run, although they will be losing relatively to others in the short run. This new perception paved the way for the important structural reform policies in the mentioned countries This was certainly the case in Argentina after the Presidency of Alfonsín, and this allowed President Menem to lead, starting in 1989, a drastic macroeconomic and structural adjustment program.

THE ECONOMIC REFORMS OF ARGENTINA DURING THE LATE 1980s AND EARLY 1990s

The general aim of the Argentine macroeconomic and structural adjustment program is to *transform the highly inflationary and distorted economy of the mid 1980s into a stable and efficient market economy, open to international trade and capital movements*. As can be inferred, the aim is about the same as that of the Chilean policy makers after the socio-economic and political crisis of the early 1970s, or for that matter, that of the recent Bolivian, Mexican, Nicaraguan, Peruvian, Salvadorian, Venezuelan, etc. governments. There are of course differences in the detailed design of the new institutions, the deepness

[51] See Packenham, R (1992).

of the reforms, its sequencing, etc. These differences reflect historical facts, differences in leadership, political power of different interest groups, etc. The basic thrust of the reforms is nevertheless the same.

The fiscal deficit and price stability

In Argentina, much more so than in Chile, reducing the rate of inflation became the highest priority In both countries macro-economic stability was, and is, considered a necessary condition for economic development However, while in Chile structural reforms always took preference above macro-economic measures to reduce the rate of inflation[52], in Argentina many of the structural reform measures were taken primarily as a way to contribute in the short-run to the reduction in the rate of inflation

Two were the main actions taken to reduce inflation, which, as might be recalled, reached hyper- inflation standards in 1989 The first, and most dramatic, was the *pegging of the exchange rate to the US$* on a one to one basis, by law. Any modification of the exchange rate requires legal approval from the legislature, which makes such a change very unlikely This was one way in which the Government tried to make this exchange rate pegging credible Of course, in a relatively internationally open market economy, the pegging of the exchange rate had to reduce, as it did, dramatically the inflation rate In fact, as measured by the Consumer Price Index, the inflation rate dropped from 3079 per cent during 1989 to 25 per cent in 1992, and is expected to reach only 9 per cent in 1993

Additional program credibility was to be gained by *eliminating the budget deficit*, or at least to reduce it to the point were no Central Bank credits were required to finance it. This was achieved by increasing and streamlining Central Government revenues, and by reducing its expenditures. To achieve the first of these objectives, value added tax rates were increased, some non-efficient taxes, like stamp taxes, were reduced, and a major and successful effort to improve the tax administration was launched Of course, the spectacular increase in tax revenues reflected in large part the well known Olivera-Tanzi effect[53]. Additional revenues were obtained through a *very ambitious privatization program*, which began by divesting

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[52] This, because it was believed that without the structural reforms necessary to accelerate the rate of growth, which in themselves often contributed very little directly to the inflation rate reduction, inflationary pressures would persist in the long-run as a consequence of the fight of different groups for a larger share of a stagnant GDP

[53] The Olivera-Tanzi effect is the reduction in tax revenues as percentage of GDP because real tax payments are diminished by inflation between the moment they accrue and they are paid The opposite of course happens when the inflation rate is reduced.

the State owned telephone company and several of the countries largest electricity companies, the overwhelming majority of which were sold to foreigners or to joint ventures controlled by foreigners[54] The program continued by selling other less sensitive companies, and is now in the process of privatizing oil. The aim is to privatize all Central Government enterprises, and to grant concessions for a significant proportion of the public works maintenance and construction The Central Government is also putting pressure on Provincial Governments to privatize its enterprises.

To reduce fiscal expenditures, practically all of the large number of existing *government subsidy programs were eliminated.* Moreover, the Government reduced employment levels at the central level, although this reduction has been in part offset by an increase of employment at the Provincial level.

Other significant reforms

However, the control of inflation was not the only objective, and many other reforms took place to improve the allocation of resources, and to provide the right incentives to save and work. Here we will only mention three of them, but there were others of significance

Perhaps the most important of these reforms was the *trade liberalization*. Tariff levels were reduced to a 0 to 22 per cent range, and the use of non-tariff barriers was diminished. The reduction in the level of the highest tariffs and of the tariff range, reduced effective tariffs significantly, and as a result, differential protection rates This implies a significant improvement in the allocation of resources. At the same time, however, Argentina joined MERCOSUR, the free trade agreement between Argentina, Brazil, Paraguay and Uruguay. As a result, these countries are diminishing trade barriers among themselves, and plan to have a common external tariff In the case of Argentina, which already has lower tariffs than the planned common external tariff, this might divert trade rather than create it, and imply a welfare loss

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[54] Only a few years ago these companies would have been considered "strategic" and divestiture would have been out of the question even to Argentine private firms, while now they were sold to foreigners The telecommunication companies in which the telephone company serving Buenos Aires was divided were purchased by U S A and Spanish interests, while most of the electricity companies were purchased by firms in which Chilean interests play a decisive role

Argentina also *freed international capital movements* completely and drastically at the beginning of the reform process. In this sense the sequencing and deepness of the reforms in Argentina differs from that in Chile. This latter country opted for a very significant trade liberalization before opening its economy cautiously to international capital movements

Finally, Argentina *deregulated* many of the sectors which viously had been very heavily intervened by the Government. This includes the very important oil industry. Taken together, the described structural reforms have radically changed the character of the economy Although the reforms in most cases were not as deep as in Chile, they were sufficient to transform the economy into a modern market economy

As in Chile, the new "model" enjoys, as pointed ove, widespread support To many expert observers its main potential weakness is the reliance of this support on the relative price stability generated by the fixed exchange rate regime. The important capital inflows since the pegging of the excahnge rate, generated excess expenditures in the non-tradable markets and mild inflation rates[55] These inflation rates accumulated over time and have appreciated the Argentine currency significantly Argentina will eventually have to correct this appreciation, and many question its ability to do it without an exchange rate devaluation The latter might, however, endanger the whole program

SOME POLICY LESSONS FROM THE ARGENTINE AND CHILEAN EXPERIENCES OF STRUCTURAL REFORM

Are there any policy lessons for Third World economies, especially Africa, to be extracted from the cases of Argentina and Chile? The answer is definitely positive. Moreover, these lessons are both about what should and should not be done

[55] Argentina suffered heavy capital flight since the late 1970s and until the beginning of the structural reform process. A very significant proportion of the present capital inflows is being generated by the return of financial resources belonging to Argentine citizens.

What kinds of policies should be avoided[56]?

The first "negative" lesson extracted from the import-substitution period which preceded reform in both countries, is that, generally, high and differentiated custom duties do not contribute to increased production and income growth These differentiated and high tariffs only *distort* the productive effort in favor of the more inefficient sectors of the economy, and therefore actually reduce the economic growth rate[57]

The second "negative" lesson derived from the same period, is that excessive and discriminatory government intervention leads inevitably to *indiscriminate rent seeking* at the expense of productive effort. Once entrepreneurs perceive that they are likely to gain more by lobbying government, they will tend to abandon their efforts to reduce costs or increase production, and will give priority to lobbying Evidently, this will lower the economic growth rate, and generate a more unfair income distribution[58].

What positive policy lessons can be derived from the cases of Argentina and Chile?

Chile, under its competitive "social" market economy, open to international trade, is experiencing rapid growth, accompanied by relatively stable prices. In a way, it has become a model, together with other countries like Mexico, for the structural reform of the remaining countries of the region Non-discriminatory *rules*, as opposed to authorities, are providing powerful incentives for the existing physical and human resources to be actively engaged in an efficient productive process Moreover, clear incentives exist to accumulate additional resources through saving and investment, and thereby, to accelerate the economic growth process That is, the existing market institutions have minimized rent seeking activities and focused the productive effort of the country to a large extend on growth instead of redistribution The Argentine experience, on the other hand, is still too

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[56] Harberger, A C (1984) derived a 10 point listing of economic policy lessons extracted from a sample of 12 case studies, which included both developed and developing economies Naya, S , Urrutia, M et al eds. (1989) compare Asian and Latin-American economic development, and also extract policy lessons from this comparative experience The aim of this paper is more modest, since the lessons presented in the text are only those extracted from the comparative structural reform experience of Argentina and Chile, and the immediately preceding period, and even so, are only limited to those few lessons which seem to be clearly outstanding and today, are generally accepted by the profession in the region

[57] See Mundlak, Y , Cavallo, D and Domenech, R (1989) for an econometric effort to measure the effect of economic distortions on the agricultural sector in the case of Argentina, and Coeymans, J and Mundlak, Y (1993) for a similar, but multi-sector study, of the case of Chile

[58] See Borner, S , Brunetti, A and Weder, B (1992)

young to draw lessons from it, although the results of the stabilization program have been impressive up to now.

A word of caution The success of the market model in Chile is in all likelihood related to the fact that during the last decades it invested heavily in the development of human resources. These expenditures deviated capital from immediately productive investments, and slowed down economic growth in the medium term, but generated a relatively capable labor base at all levels, especially technical and professional Once the economy opened up to international trade, the country was therefore able to rapidly absorb the latest technologies, and compete internationally In addition, especially as compared with many of the less developed countries of Africa and other continents, Chile enjoyed a basic, relatively modern productive infrastructure[59] The case of Argentina is, in this sense, not too different from that of Chile

It would therefore be a mistake to suggest that the successful experience of Chile, and apparently also that of Argentina, should lead other developing countries to liberalize and deregulate their economies as significantly and rapidly as these two Even so, it might be worthwhile *to consider* the following measures even under other contexts:

(a) allow, as a general rule, the functioning of free markets for goods and services[60]. If these markets are not naturally competitive because of the size of the market, which will often be the case as it was in Argentina and Chile, use an open trade policy to discipline them, rather than regulate the existing Public or Private Sector monopolies The reduction in the average rate of protection will be compensated automatically by a real exchange rate adjustment, as occurred in Chile and many other countries, and will allow a large proportion of the protected activities to compete successfully Some industries will have to close down, but other activities will expand, and more than compensate, even in the short-run, most of the negative output and employment effects of the former, generating a better allocation of resources. Use transparent and prudent taxes and subsidies, if a different than free market allocation of resources is wished

(b) allow free entry into most, if not all, markets, and force State Owned Enterprises by law, as was done in Chile, to function without *special* subsidies, to be able

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[59] Roads, ports, air-ports, telecommunications, etc.
[60] This implies free prices, interest rates and wages.

not be useful to others. However, the path from protectionism and excessive and discriminatory government intervention has allowed both, Argentina and Chile, to perceive a brighter future, and that is no small achievement.

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IV
Development Issues

Adjustment Policy and Agricultural Development (*)

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1. Introduction

This paper considers the effects of macroeconomic adjustment policy -including stabilization and structural adjustment- on the agricultural sector and, hence, on economic development in general. Evidently, these effects differ by country; this paper refers mainly but not exclusively to African countries.

Most Sub-Saharan African countries have balance of payments deficits and have been led to adopt adjustment policies. Some countries adopted adjustment policies at the end of the seventies or at the beginning of the eighties; others adopted these policies more recently. Because of the economic importance of the agricultural sector in these countries, the effects of policy reform can be partly evaluated by their impact on agriculture.

The effects of adjustment on the agricultural sector are not easy to evaluate because agriculture, more than other sectors, is affected by exogenous factors independent of economic policy. Moreover, it takes a long time for agricultural output to react to changes in incentives.

Table 1 shows the average trend of real agricultural value added for two nine-year periods, between 1970 and 1988 for several subsets of countries. During the eighties, agricultural growth of Sub-Saharan African countries remained below that of the other developing countries. The African countries that applied on adjustment policy during the eighties with the support of the Bretton Woods Institutions for at

(*) This paper is a revised version of a communication presented at the "Congress of International Association of Agricultural Economists", Tokyo, August 1991.

least three years show moderate improvement in agricultural growth compared with that of the seventies; this is not the case for the non-adjustment African countries. It should be noted here that these figures are only averages that have been calculated from incomplete and often not very reliable data, and also that there are deviations with the subsets. Moreover the timing of adjustment, earlier or later during the eighties, may have affected this period average results.

Although the observed results about agricultural growth have not been corrected for the influence of exogenous or environmental factors[1], this does not mean that we must reject the assumption that adjustment policies and programs have favourable effects on agricultural growth. However, the deviations within the results lead the author to think that adjustment policies, as applied, have not always had the effect intended[2]. This may be because the effects of the main instruments of adjustment policy are not automatic, as is sometimes assumed. These instruments lead to trade-offs that can be, but are not necessarily favourable to the agricultural sector.

Summary

This paper surveys the main relations between adjustment policy and agricultural performance during the eighties, with special focus to African countries. First it shows why logically adjustment may favour agricultural development. Then it considers why the implementation of the main policy measures may not lead to the expected results. Special attention is given to the exchange rate policy (a strong currency depreciation is often associated with a decline in real producer prices), to the trade liberalization (and the conditions of an efficient producer price stabilization) and to the fiscal policy (decreasing fiscal deficit has different consequences on the agricultural sector depending on the tax increases and expenditures cuts).

[1]An attempt to eliminate this influence from the observed results is presented by Goi, 1988.
[2]We consider here the effect of structural adjustment policies on agricultural output growth, and not the more general problem of their effect on the social situation in rural areas. On that point see Azam, Chambas, Guillaumont P., and Guillaumont, S., 1989.

2. How adjustment favours agricultural development. The logical case.

Structural adjustment means less external deficit for a given amount of overall growth or more overall growth for a given deficit. Such an outcome requires a change in the structure of production, leading to a larger share for tradable goods (either exports or import substitutes)[3]. In a market economy, this structural change results from the increased profitability of the tradables produced. This profitability can come from two sources: one, an increase in the relative price of the tradables in question; the other, an increase in factor productivity.

So defined, structural adjustment is distinct from macroeconomic stabilization, which means reducing the external deficit through lowering domestic demand, hence leading to lower growth. However, these two ways to adjustment are often complementary over time. Structural adjustment involves the development of markets that work well, and then avoiding high inflation or acute shortages. The economy then restores macroeconomic balance through stabilization measures.

Each of the two aspects of structural adjustment (relative prices and productivity) has strong implications for agriculture.

Relative price changes and agricultural growth

An increase in the relative price of tradables (or a decrease in the price of non-tradables -the so-called decrease in the real exchange rate) is a priori favourable to the agricultural sector, in so far as this sector produces tradable goods in a larger proportion than the other sectors. Not only export goods but also most food crops are tradables: rice maize, millet, and niebe are traded between African countries, often with less tariff or administrative obstacles than that encountered by manufactured goods. Of course, food crops are also retained for the farmers' own use.

[3]More details on adjustment concepts can be found, for example, in Guillaumont, P., 1985; and Guillaumont, P. and Guillaumont, S., 1990b, c, 1991a.

It is generally admitted that a structural adjustment policy leads to an increase in agricultural prices relative to the price of other goods and services. Such an increase is often a reversal of the trend registered during the seventies in numerous developing countries, especially in Africa (where there was deterioration in the internal terms of trade). As such, structural adjustment normally leads to a lessening of "urban bias".

If a structural adjustment policy actually leads to an increase in the relative or real price of agricultural products, which is not always the case as will be seen, agricultural production would be expected to rise. The question of how far has been debated at length. Some conclusions from this debate follow[4].

- The price elasticity of agricultural supply depends on the working of the rural markets: when farmers cannot sell their output or when they do not find anything to buy with their money, elasticity is lower, and may even become negative.
- Long-term price elasticity is higher than shorter-term price elasticity, especially for perennial crops and in irrigated agriculture, or more generally when investment is needed to increase output.
- In the short term, rice elasticity of single products is significantly higher than that of the global agricultural supply. When the price of a single product increases, its output can be increased by replacing other crops. Global supply is limited by the available production factors, which may be fully used. In the long term, an increase in the global agricultural supply involves productivity improvements.

Productivity improvements and agricultural development

For the last ten years, structural adjustment has often been considered as a problem of "getting prices right". However, productivity improvements, the other

[4]See, for instances, on these questions: Binswanger, 1989; Bond, 1983; Bonjean, 1990c; Bonjean and Marodon, 1988; and Chibber, 1988. On the particular problem of the influence of consumer goods markets, see Azam, Berthelemy and Morrisson, 1991; Azam and Faucher, 1988, Berthelemy and Morrisson, 1990; Bevan, Collier, and Gunning, 1989; and Guillaumont and Bonjean, 1991a.

element in structural adjustment, are needed as well. They are complementary to relative price changes wherever they occur, in agriculture or in other sectors.

The agricultural production of developing countries is, more than that of other sectors, limited by the availability of primary production factors. Productivity improvements, then, are particularly needed to increase production. The relative price increase of agricultural goods, which makes their production more profitable, provides an incentive for technical progress in agriculture. This is a reason why the long-term price elasticity of supply is probably higher than short-term elasticity, although there are difficulties in testing this assertion.

Indeed, in the long term, factors other than prices influence agricultural productivity, either directly or through the parameters of price reactions: health and education in rural areas, agricultural extension, agronomic research, quality of feeder roads and other communication means, access to credit, and so forth.

It is, however, not only the productivity improvements that occur directly in the agricultural sector that are favourable to agricultural development and structural adjustment[5]. Productivity improvements in other sectors can increase the relative price of agricultural goods. This is the case either when productivity improvements lead to a decrease in the price of goods (inputs or consumption goods) bought by the farmers, or when they lower processing, transportation, or marketing costs of agricultural products, which allows a better price at the farm gate for a given border price.

To reiterate, structural adjustment, by definition, is in most developing countries favourable to the agricultural sector, even if it is a time-consuming approach. It relies on two complementary means: a rise in the relative price of agricultural goods and productivity improvements. But a structural adjustment policy that aims at these

[5]The conditions for this are studied in Guillaumont, P. and Guillaumont, S., 1990b, 1991a.

two objectives and also at maintaining macroeconomic balances requires choices and trade-offs that are sometimes difficult and not always favourable to agriculture.

Diversity of the instruments of structural adjustment policy and their effects on agricultural development

Structural adjustment policy provides for the use of many instruments in the economic policy spectrum, such as monetary and fiscal policy, public sector management, public investment choice, rate of exchange policy, and price and trade policy. Adjustment programs combine these different instruments in various ways: they focus to varying degrees on restoration of macroeconomic equilibrium, on elimination of price distortions, or on productivity improvements. These choices are differentially favourable to the agriculture sector.

The main relevant choices we consider in the remainder of this paper are devaluation (strong or moderate) versus maintaining parity, total price liberalization versus maintaining some regulated or stabilized prices, and public expenditure reduction (or varying amounts) versus an increase in public receipts to reduce the budget deficit. Each of these three choices has an impact on agriculture that is never mechanical. Most often, this impact depends on political economy consideration.

3. Rate of exchange policy, real producer prices and productivity[6]

Most of the countries that have applied an adjustment policy with the support of the IMF have been led to devalue several times or to adopt a floating rate. Noticeable exceptions are the franc zone countries and Liberia in Africa, and Haiti and Panama.

[6]The implications of an adjustment with or without devaluation are more thoroughly examined in previous work, especially Guillaumont-Jeanneney, S., 1988; Guillaumont, P. and Guillaumont, S., 1990b; and Guillaumont, P., Guillaumont, S., and Plane, 1991.

Expected and observed effects of devaluations on real prices

Devaluation is an essential instrument for structural adjustment, because it normally leads to a change in the ratio of tradable to non-tradable prices -in other words, to a change in the real exchange rate. Devaluation aims at increasing the profitability and thus the volume of exports or of import substitutes[7]. Currency depreciation means a rise of the border price of exported or imported agricultural goods expressed in domestic currency, which ceteris paribus increases the profitability of the production of these goods.

However, the expected effect of devaluation as an agricultural incentive is not automatic. The reason is that real producer prices are determined by the real international price of the agricultural products, by the real exchange rate, and by the rate of the levy that occurs between the border and the gate -that is, the rate of the public levy and the transportation and marketing costs[8]. So the increase of the nominal border price due to currency depreciation may not lead to an increase of the real producer price for two reasons. One is the domestic inflation induced by devaluation, which means that a decrease in the nominal exchange rate results in a lower decrease in the real exchange rate (in other words, the devaluation is more or less "effective"). The other reason is that the increase in the nominal border price is not passed on entirely to the producer, because one part of it is kept by the state through marketing boards and progressive taxation or by monopolistic trading networks. So devaluation has a real incentive effect on agriculture only under some conditions[9].

The figures in Table 2 show that from 1980 to 1988 these conditions were not always satisfied. Contrary to expectations, adjusting countries whose currency was strongly depreciated (20% a year or more on average during the period) are the

[7]The point here is not to know if the growth of some agricultural production due to adjustment policies may lead to a significant decrease of international prices.
[8]The relationship between international prices, real exchange rate and real producer prices is examined in particular by Guillaumont, P. and Guillaumont, S., 1990c; Guillaumont and Bonjean, 1991b; Guillaumont, P., Guillaumont, S., and Plane, 1991; and according to a different method by Krueger, Schiff, and Valdes, 1988.
[9]See a more developed explanation in Guillaumont (P. and S.), 1992.

countries in which the trend of real producer prices was the least favourable, both for food and for export crops. The trend of real producer prices appears to be positive (on average) only in the group of adjusting countries that did not devaluate. The results hold for the whole sample of 85 (87) developing countries and the African subset. In Latin America, the few countries with moderate devaluation (less than 20% a year on average) show a better performance in real producer prices, in contrast with the strongly depreciating countries of these regions.

These results could come from differences in the trend of the international price of the products exported by the various country categories. To eliminate the influence of this factor, we have calculated, for the main export crops of each country, the trend of the ratio between the real producer prices and the real unit value of the exported goods. This trend, calculated for 65 developing countries, is highest in the non-adjusting ones and in the adjusting countries without devaluation, and lowest in the strongly depreciating countries. Again only in Latin America does the category of countries with moderate depreciation (only four countries) perform as expected, showing the highest trend.

Economic policy implications

A choice between adjustment with or without devaluation is not always possible. A strong decrease in the nominal official rate was unavoidable in Ghana, Guinea, and Tanzania, for example, because these countries had high inflation, strongly appreciated real exchange rates, and, simultaneously, strict exchange controls associated with a foreign exchange shortage that resulted in a large parallel market for foreign exchange, with a large gap between the official rate and the parallel one. The main aim of the devaluation was to unify the foreign exchange market and to integrate the informal or parallel transactions into the official ones. It is difficult to estimate the effect of such depreciations on agricultural activity: indeed a significant increase in agricultural exports occurred in the depreciating countries (Balassa, 1990), but the share of the increase due to the transformation of unofficial into official transactions is not known.

Some African countries that had not registered a strong appreciation of their real exchange rate could choose to adjust with or without devaluation.

The implications of an adjustment without devaluation have been debated extensively[10]. Franc zone African countries that made such a choice succeeded in lowering their real exchange rate, at least to some extent, and during a certain period of time, they did so thanks to the depreciation of the French franc (until 1986), but also by a disinflation policy that lessened domestic price increases, bringing these increases below the world inflation rate.

Thus one main difference between countries adjusting with or without inflation is the following: the first adjust through inflation and money illusion; the others with disinflation, with makes a difference for agriculture. Inflation can be particularly dangerous in agriculture for two main reasons. First, small farmer savings may be held principally in cash, whose value is lessened by inflation. Second, inflation generates uncertainty about prices, which slows down innovation.

Another difference between the two categories of countries is a lower real exchange rate depreciation in countries that have not devalued. But maintaining parity provides an incentive for those countries to look for other means of adjustment. Thus franc zone countries have been led to lower taxation on agricultural exports (groundnuts, cotton) -a means necessarily limited by budget constraints- and to look for productivity improvements in agro-industrial activities. One most interesting case is that of cotton during the fall of world cotton prices in the mid-eighties. The

[10]This question is debated in length in Guillaumont, P., and Guillaumont, S., 1990b; and Guillaumont, P., Guillaumont, S., and Plane, 1991.

profitability of the cotton sector has been maintained, thanks mainly to economies achieved in transportation, marketing, and processing.

Briefly stated, devaluation is assumed to act on supply largely through an increase in real agricultural producer prices, but a stronger depreciation does not necessarily lead to higher real prices. This depends on the effectiveness of the devaluation in real terms, or in other words on the macroeconomic policy applied. The need to reduce the budget deficit often leads governments to use devaluation for that purpose, rather than to increase producer prices. As for adjustment policy without devaluation, it must rely on productivity improvements. These improvements, when achieved outside agriculture, have in turn a positive effect on producer prices.

4. Trade liberalization and the problem of producer price instability

In Africa, adjustment programs have to some degree included liberalization of domestic trade and prices, in particular of agricultural prices. Liberalization is a natural way to achieve structural adjustment, because market mechanisms and efficient competition are supposed to eradicate price distortions[11]. Liberalization also has macroeconomic consequences.

Agricultural prices are necessarily liberalized in countries with floating exchange rates and where currency is depreciating fast (Guinea Bissau and Zaire, for example): in those countries, administered prices would have to be permanently revised and would have no real meaning. But in countries with a relatively stable rate of exchange, the regulation of some prices remains possible, although not necessarily advisable.

[11]The problem of the liberalization of external trade, often linked to that of domestic trade, is not considered here and is complex. Protectionism raises the price of importable agricultural goods as the objective of structural adjustment advocates, but on the other hand it raises the cost of food and then of labour, which lessens the competitiveness of the other products. Moreover, it is often ineffective.

Food crops

Liberalization has probably been stronger in the food sector for several reasons. Boards in charge of stabilization of food prices have often been particularly inefficient (a large share of the transactions remain outside their purview) and costly (for example, OPAM in Mali and OPVN in Niger). Moreover, when price fluctuations are linked with supply variability, this stabilizes farmer income to some degree. There is, however, room for limited state intervention in the market, for instance through security stocks.

It is difficult to evaluate the recent experience in grain trade liberalization, in particular African countries. Cereals output noticeably increased during recent years in countries where liberalization occurred (Sahel and Madagascar), but a simultaneous improvement in weather conditions also occurred[12].

Export crops

For export crops[13], much doubt has also arisen abut the possibility of an efficient price stabilization scheme for a least two reasons. One is the risk of delinking domestic prices from international prices, thereby giving up comparative advantage. Another risk is that stabilization mechanisms have been diverted from their initial role and transformed into instruments for excessive agricultural taxation. The track record of stabilization funds and marketing boards has generally been poor: these boards were used to taxing the agricultural sector, and the money levied when international prices were high was spent and was not available when these prices fell. As a result, adjustment programs have often attempted to eliminate these institutions, which have been characterized as parasitic.

[12] On the experience of Niger see Bonjean in Guillaumont, P. and S., 1991a, and on that of Madagascar, Berg, 1989.
[13] About this question, see Guillaumont, P. and S., 1990a, 1990c, 1991b; Guillaumont P. and Bonjean, 1991a, 1991b; Knudsen and Nash, 1990; Lele and Christiansen, 1989; Mellor and Raisuddin, 1988; and Schiff and Valdes, 1990.

The principle itself of producer price stabilization for export crops remains a relevant aim in an adjustment policy. It is well known -in particular because of risk aversion- that, for a given average price, output is higher with a stable price than with an unstable one. Moreover, price instability is probably a brake to innovation and investment, especially for small farmers. After all, instability does not affect only the farmers. Public income instability disturbs macroeconomic management, as evidenced by the literature about Dutch disease. Public policy must focus on the joint objective of producer price stability and public revenue stability.

To avoid previous errors, stabilization of producer prices and of public income can be achieved efficiently only under two conditions, both of which are realizable. One is that price stabilization rely not on a fixed price but on the trend of the observed international price, to avoid misallocation of resources. The other is that stabilization funds be absolutely independent of the tax levy and statutorily deposited outside the reach of the public treasury, to avoid their disappearance and the risk of Dutch disease[14].

Some countries have maintained some partial stabilization schemes, such as Papua New Guinea for several products or French-speaking African countries for cotton (or for hevea in Côte d'Ivoire). These schemes, the modalities of which may be a matter of debate, aim at establishing some stability in producer prices without delinking them from international prices, and ensuring that the funds are unavailable to the public treasury.

The choice for more or less stability in producer prices is not actually independent of exchange rate policy. It can be noted (Table 3) that during the eighties the instability of real producer prices (both for food and export crops) was highest in the countries in which monetary depreciation was strongest. It was lowest in countries

[14]See a discussion of these principles and of costs and advantages of the various schemes of export crops producer prices stabilization in Guillaumont, P. nd S., 1990a, 1991b.

adjusting without devaluation or with moderate devaluation. These results appear in the whole sample and in each of the two subsets (Africa and Latin America). To check for the influence of unstable real international prices, the author defined a stabilization coefficient as the difference between this instability and that of real producer prices. The coefficient of stabilization (from 1979 to 1988) was highest in the non-adjusting countries, followed by the countries adjusting without devaluation, and then by the counties with moderate devaluation, and was lowest in the countries with strong depreciation.

In sum, liberalization policy involves a mix between the correction of price distortions and the search for an environment favourable to improvement of productivity. Monetary stability favours real producer price stability for food crops and is a necessary but not sufficient condition for the efficient stabilization of (real) producer prices for export crops.

5. Decreasing the budget deficit, agriculture taxation and public expenditure

As seen above, structural adjustment involves a preliminary or simultaneous reduction of the budget deficit, so it requires a mix of tax increases and public expenditure decreases.

The ability to increase public revenues has apparently been particularly difficult in African countries, although the tax-GDP ratio is low compared with other areas. This difficulty has occurred because taxes are levied mainly on external trade, and because such taxes are more easily imposed n those transactions than on domestic transactions or on domestic incomes. But structural adjustment logically involves lowering taxes on external trade, which is a source of distortion.

Some countries that devalued at first to change relative prices, however, have been tempted to increase the levies on agricultural exports. This policy made it easier to balance public finances but, as seen above, did not lead to the expected increase in real producer prices (for example, in Madagascar from 1982 to 1986). Stabilization objectives then prevailed over structural adjustment.

To reduce the deficit without increasing revenues, adjusting countries were then led to diminish public expenditures. The various categories of expenditures were not reduced equally. Most often, because it was easier, rural expenditures declined more than urban ones, capital expenditures more than current expenditures, and, among these, working expenditures more than salaries. It seems that the expenditures allocated to agriculture, in particular those on which agricultural productivity depend, were significantly affected[15]: these expenditures are rural and they are in large part investment expenditures (for infrastructure) or expenditures for services that are particularly needed (such as health, extension, and research).

The evolution of agricultural public expenditures varies according to the kind of adjustment policy adopted and especially the exchange rate policy. Currency depreciation increases somewhat the ratio of public income to GDP, because revenues depend mainly on taxation of tradables. Higher revenues, in turn, lead to higher ratios of public expenditure to GDP. But currently depreciation also tends to increase expenditures allocated to the purchase of tradables, particularly to servicing external debt. Thus, the relative share of other public expenditures is likely to decrease. This may occur for expenditures on agriculture, which have a relatively high tradables content. Thus, the impact of currency depreciation on the agricultural expenditures-GDP ratio is uncertain (as is the comparability of data about these expenditures).

The figures in Table 4 show differences among country groups in the evolution of agricultural public expenditures from 1970-1979 to 1980-1988. The reduction of their share in total public expenditures as well as in GDP is higher in adjusting than

[15]This has been noted by Mosley, 1989, for several African countries.

in non-adjusting countries. Among adjusting countries, the share in GDP decreases on average only in the category of countries with strong depreciation and it increases only in countries with moderate depreciation.

Briefly stated, the choice or mix between increased taxes and lower expenditures involves some trade-off between the two paths to structural adjustment: correction of price distortions and productivity improvements. Choosing less public expenditure may be better for agricultural prices, but is likely to be unfavourable to agricultural productivity. The countries with strongest currency depreciation programs seem to be those in which agricultural expenditures have been affected more (although they have not succeeded in raising real produce prices).

To sum up, structural adjustment policies are theoretically favourable to agricultural development, because they aim at improving price incentives and productivity. In practice, particularly in Sub-Saharan Africa, structural adjustment has on balance improved the pace of agricultural growth. But structural adjustment has not always succeeded in doing so, for several reasons:

- During the application of these policies, agricultural sectors faced several shocks because of the climate or of changes in the international markets.
- Adjustment policies were applied for varying periods of time and with different degrees of public involvement; reaction lags in agriculture may be long.
- These policies used various combinations of different instruments, the effects of which are never automatic; as a result, illustrated above by the rate of exchange policy and trade liberalization and budgetary policy, an unequal weight was given by countries to the elimination of price distortions and to productivity improvements.
- The two means of structural adjustment and macroeconomic stabilization are largely complementary for agricultural development, but their combination has not

always been optimal. Thus it remains useful to study how economic policy can promote agricultural development, in Africa and elsewhere.

Table 1
Rate of Growth of Agricultural Value Added

(1980 constant prices) (%)

Simple Average	1970-1979	1979-1988	Difference (same sample)
LDC	2.9 (85)	2.8 (92)	-0.2 (82)
- adjusting	2.4 (42)	2.4 (41)	-0.1 (41)
without devaluation	1.9 (10)	1.8 (9)	-0.1 (9)
with moderate depreciation	2.3 (15)	2.7 (15)	0.4 (15)
with strong depreciation	2.8 (17)	2.3 (17)	-0.5 (17)
- non adjusting	3.3 (43)	3.1 (51)	-0.2 (41)
SUB-SAHARAN AFRICA	2.2 (35)	2.0 (36)	-0.2 (35)
- adjusting	1.9 (20)	2.3 (20)	0.4 (20)
without devaluation	1.7 (7)	1.9 (7)	0.2 (7)
with moderate depreciation	1.5 (6)	2.8 (6)	1.3 (6)
with strong depreciation	2.6 (7)	2.2 (7)	-0.4 (7)
- non adjusting	2.6 (15)	1.6 (16)	-0.8 (15)
LATIN AMERICA	2.7 (24)	1.9 (28)	-1.3 (23)
- adjusting	2.7 (12)	1.8 (11)	-0.9 (11)
with moderate depreciation	2.4 (4)	0.2 (3)	-2.2 (3)
with strong depreciation	2.9 (8)	2.5 (8)	-0.4 (8)
- non adjusting	2.8 (12)	1.9 (17)	-1.7 (12)

Table 2
Trend of Real Producer Prices
(1979–1980)

(Linear Adjustment)

Simple Average	Food Crops	Export Crops	Trend of the Export Crop Producer Price Index to Real International Price Index Ratio
LDC	-0.8 (85)	-1.2 (87)	7.6 (65)
- adjusting	-2.1 (40)	-2.1 (40)	6.5 (33)
without devaluation	0.3 (10)	1.5 (10)	8.4 (8)
with moderate depreciation	-1.7 (14)	-1.6 (14)	7.1 (10)
strong depreciation	-4.1 (16)	-4.8 (16)	5.0 (15)
- non adjusting	0.3 (45)	-0.5 (47)	8.8 (32)
SUB-SAHARAN AFRICA	-1.1 (36)	-1.3 (37)	9.8 (26)
- adjusting	-2.4 (20)	-2.3 (20)	5.3 (14)
without devaluation	0.9 (7)	2.5 (7)	8.5 (5)
moderate depreciation	-2.8 (6)	-4.9 (6)	1.7 (3)
strong depreciation	-5.3 (7)	-4.7 (7)	4.5 (6)
- non adjusting	0.6 (16)	-0.3 (17)	15.1 (12)
LATIN AMERICA	-0.4 (24)	-0.3 (26)	6.9 (22)
- adjusting	-1.9 (10)	-0.9 (11)	8.8 (11)
moderate depreciation	-0.6 (3)	5.8 (4)	16.4 (4)
strong depreciation	-2.4 (7)	-4.8 (7)	4.5 (7)
- non adjusting	0.4 (14)	0.1 (15)	5.2 (11)

Table 3
Instability of Real Producer Prices
(1979-1988)

Simple Average	Food Crops	Export Crops	Degree of Stabilization of Producer Prices for Export Crops
LDC	12.4 (75)	13.4 (75)	7.0 (51)
- adjusting	13.5 (37)	15.9 (36)	2.8 (26)
without devaluation	7.2 (10)	8.2 (10)	9.6 (7)
moderate depreciation	7.2 (14)	10.5 (14)	4.3 (10)
strong depreciation	25.1 (13)	28 4 (12)	-3.9 (9)
- non adjusting	11.3 (38)	10.9 (39)	11.4 (25)
SUB-SAHARAN AFRICA	13.8 (34)	12.9 (35)	7.2 (25)
- adjusting	12.8 (19)	14.9 (19)	1.1 (13)
without devaluation	7.7 (7)	9.4 (7)	9.9 (5)
moderate depreciation	8.4 (6)	11.1 (6)	1.2 (3)
strong depreciation	23.3 (6)	25.2 (6)	-7.8 (5)
-non adjusting	15.1 (15)	10.4 (16)	13.8 (12)
LATIN AMERICA	15.6 (19)	20.1 (19)	3.3 (12)
- adjusting	20.7 (8)	24.8 (9)	-0.6 (6)
moderate depreciation	5.8 (3)	12.3 (4)	-0.3 (3)
strong depreciation	29.7 (5)	34.8 (5)	-0.9 (3)
- non adjusting	11.9 (11)	16.0 (10)	7.3 (6)

Table 4
Evolution of Public Expenditure on Agriculture

Simple Average	in % of GDP 1970-1979	in % of GDP 1980-1988	in % of GDP difference (same sample)	in % of total expenditure 1970-1979	in % of total expenditure 1980-1988	in % of total expenditure difference (same sample)
LDC	1.7 (84)	2.1 (85)	0.3 (74)	7.4 (87)	7.2 (86)	-0.5 (69)
- adjusting	1.6 (37)	1.6 (39)	0.0 (35)	7.5 (37)	6.3 (38)	-1.2 (32)
without devaluation	1.6 (7)	1.6 (9)	0.0 (7)	6.5 (7)	5.6 (9)	-1.8 (6)
moderate depreciation	2.0 (15)	2.5 (14)	0.5 (13)	9.2 (15)	9.2 (13)	-0.4 (13)
strong depreciation	1.2 (15)	0.8 (16)	-0.3 (15)	6.2 (15)	4.4 (16)	-1.7 (13)
- non adjusting	1.7 (47)	2.4 (46)	0.5 (39)	7.3 (50)	7.8 (48)	0.2 (37)
SUB-SAHARAN AFRICA	2.0 (33)	2.3 (30)	0.3 (27)	8.9 (33)	7.6 (30)	-1.0 (25)
- adjusting	1.9 (18)	1.8 (19)	-0.1 (17)	8.8 (18)	7.2 (19)	-1.9 (15)
without devaluation	1.5 (5)	1.7 (7)	0.1 (5)	7.1 (5)	6.0 (7)	-2.1 (4)
moderate depreciation	2.7 (6)	3.0 (5)	0.3 (5)	11.3 (6)	10.3 (5)	-1.9 (5)
strong depreciation	1.6 (7)	1.1 (7)	-0.4 (7)	7.9 (7)	6.2 (7)	-1.9 (6)
- non adjusting	2.1 (15)	3.1 (11)	0.8 (10)	8.9 (15)	8.3 (11)	0.3 (10)
LATIN AMERICA	1.4 (25)	1.7 (24)	0.3 (21)	6.2 (24)	5.7 (23)	-1.5 (15)
adjusting	1.1 (9)	0.6 (9)	-0.3 (8)	5.9 (9)	3.7 (9)	-1.7 (8)
moderate depreciation	1.6 (3)	0.8 (2)	-0.3 (2)	6.2 (3)	3.9 (2)	-1.9 (2)
strong depreciation	0.9 (6)	0.6 (7)	-0.2 (6)	5.7 (6)	3.6 (7)	-1.6 (6)
- non adjusting	1.5 (16)	2.2 (15)	0.6 (13)	6.4 (15)	7.0 (14)	-1.2 (7)

Table Notes

General Points

Data in brackets correspond to the number of observations of the sample on the considered period.

The differences between two periods are calculated on a common sample.

Table 1

The rate of growth of the agricultural value added at constant prices has been calculated by exponential adjustment

Sources of data: World Tables (WB)

Table 2

Nominal producer prices for export or food crops have been deflated by the consumer price index (or GDP deflator).

Real price index for each country has been calculated from an arithmetic average of real producer price indexes, weighted by the relative importance of the main selected products in agricultural production

Figures on Table 2 correspond to the angular coefficient of the linear trend.

Price data have been collected in the annual statistics of FAO.

Table 3

Real producer price instability is the average quadratic deviation from linear trend in percent.

Stabilization degree is the difference between international price instability and real producer price instability for export crops.

Table 4

Data on public agricultural expenditures have been collected in Government Finance Statistics Yearbooks (WB).

Because of missing data averages have been calculated from limited samples.

Data on GDP come from World Tables.

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POLICY BIASES, SMALL ENTERPRISES AND DEVELOPMENT

by Robert C. Young
USAID/USDOL

SUMMARY

Because of both their employment and productivity, small enterprises are vital to development. While small is not always beautiful, small firms are often more efficient in total resource use than the larger ones in sectors where the small predominate. Moreover, small enterprises are often productive in spite of policies that are biased against them, particularly agricultural, financial, and trade policies.

While there are no policy panaceas, important patterns are apparent. Policy strategies, including large and small scale enterprise emphases, are discussed for hard and soft states and Africa. In countries with very low incomes and untapped agricultural potential, reform of agricultural policies often must receive top billing. Policy reforms should be pursued through donor and host country collaboration.

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POLICY BIASES, SMALL ENTERPRISES AND DEVELOPMENT

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SMALL ENTERPRISES' VITAL ROLE

In the less industrialized world's struggle for survival and development, small scale enterprises (**SSEs**) are critical. As many as a billion or so very poor workers may own or work in such firms.[2] In the words of an ILO report from the late 1970s:

> for the greater part of the poverty group the small enterprise is the only activity in which they can usefully hope to be engaged, particularly in the immediate future.[3]

Small enterprises have been widely assumed to offer significant development potential. The small scale sector played an important role in classic development success stories -- e.g., Japan, Taiwan, and Hong Kong -- and, incidentally, continue to be important in developed economies.[4] In the words of a popular development economics text, it was hoped that SSEs would "generate more employment, permit greater decentralization, promote income equalization, and mobilize latent entrepreneurs."[5]

Yet SSEs are not universally acclaimed. South Korea dramatically illustrates that rapid growth with considerable equity is possible with a large enterprise emphasis. Large firms humble the small in appearance, are impressive political symbols, and dramatically demonstrate apparent benefits of large enterprises as the means to growth. Bigger enterprises have relatively more access to the credit, technology, markets and expertise needed for development. Moreover, large firms have the advantage of economies of scale and an impressive potential ability to earn precious foreign exchange.

THE IMPORTANCE OF SSE POLICY ANALYSIS

Heavy demands upon scarce development resources preclude providing direct assistance to the vast majority of SSEs. However, providing an improved policy climate, and removing undue policy constraints, does support the majority of SSEs. Analysts have known for some time that the policy environment for SSEs should be a healthy one, lest the efficiency of the sector and the economy as a whole be crippled.[6] Moreover, a priority for such policy reform was recently reaffirmed by an OECD seminar on the informal sector:

> As for how to intervene, the analysis suggested that donors should prioritize their actions first to sort out policy-related problems, improve effectiveness and efficiency of institutions, and lastly to focus on direct, supply-side support.[7]

In the early 1980s, however, little research had focused on the impact of policies on SSEs or the dynamics of SSEs through the long-term development process.

THE PROJECT: To improve understanding of the relationship between policies and small and medium enterprises (SMEs) in development, and building upon a program of research on SSEs,[8] USAID established the **Employment and Enterprise Policy Analysis (EEPA) Project**. The Harvard Institute for International Development (HIID), with a distinguished history of policy analysis in developing countries, was selected as the prime contractor. HIID subcontracted with Michigan State University (MSU) and Development Alternatives, Incorporated (DAI) in order to mobilize their extensive experience analyzing the economics of small enterprises.

To limit the scope to resources available, the project focused on the impact of policies on manufacturing enterprises, analyzing that sector by scale, defined by number of employees. The manufacturing emphasis was determined by manufacturing's unusually important role in development, such as in technology and productivity improvements and the earning of critical foreign exchange.[9]

On Firm Efficiency, by Size: To provide a foundation for analyzing the impact of policies on enterprise scale, EEPA analyzed the relatively efficiency of small, medium and large-scale enterprises. Related literature was reviewed and more research was undertaken on the topic. Although space limitation precludes elaboration here, those findings are briefly summarized below:

-- SSEs are beautiful in terms of efficiency only in some sectors, but, in less industrialized countries, those sectors are commonly where small enterprises are most prevalent, with traditional, labor-intensive and low average labor productivity technologies.
-- The pattern of evolution through development is for the small manufacturing firms to gradually yield to more efficient medium-sized and large firms.
-- This evolution appears determined by the correlations between different economies of scale (e.g., financial, technological and marketing), the scale of markets, and changing patterns of demand as development progresses.[10]

POLICY IMPACTS ON SMALL ENTERPRISES

In a nutshell, economic policy biases often constrain small-scale and informal sector enterprises and may offset positive effects of direct credit or technical support to them. Biases in trade, agriculture, and finance are particularly problematic. As small firms are often excluded from or neglected by the administration of tax and labor laws, such policies often are biased de facto in favor of smaller firms, although with a less potent effect.

EEPA's first "Discussion Paper"[11] found a complex set of policies affecting SSEs. Monetary, fiscal, labor, trade, price, and regulatory policies yielded a mixed bag of weak, strong, positive, and negative impacts. Biases generally favored larger enterprises and undercut efficient growth. In contrast to the general pattern, India's policies have been strongly supportive of SSEs but with doubtful benefits for development.[12] In happy contrast with both the general and India's pattern, Taiwan's policies since the early

1960s have been highly effective, supporting both growth and SMEs. The following table indicates some of the limited data available:

POLICY-INDUCED FACTOR PRICE DISTORTIONS IN LARGE AND SMALL NON-AGRICULTURAL ENTERPRISES
(the percent difference in large firms' costs relative to small firms')

	Period	Percent Difference in Labor Costs	Percent Difference in Capital Cost Owing to: Trade Regime	Interest Rate	Taxes	Total Capital	Percent Difference: Wage/Capital Rental Rate
Asia:							
Hong Kong	1973	0	0	0	0	0	0
Pakistan	1961-64	0	-38	-44	+22	-60	+150
S.Korea	1973	0	-5	-35	+10	-30	+43
Africa:							
Ghana	1972	+25	-25	-42	+26	-41	+119
SierraLeone	1976	+20	-25	-60	+20	-65	+243
Tunisia	1972	+20	-30	-33	NA	NA	NA
Lat.America:							
Brazil	1968	+27	0	-33	NA	NA	NA

NA: data not available   Source: Haggblade et al., p. 31

While these data reflect considerable variability, patterns are there. For these countries, capital market distortions (apart from Hong Kong) are widespread and substantial, and labor market distortions were significant in Africa but still much less than those in capital markets. More specifically, the predominant pattern in these cases is a net effect of lower capital costs and higher labor costs for the large firms. This substantially inflates the wage/capital cost ratio and is a powerful incentive for large firms to pick labor-saving and capital-intensive technologies in spite of the typical relative abundance and low cost of labor.

Beyond these microeconomic effects, quantitative analyses of macro impacts were scarce and fraught with substantial analytical problems. Although the estimates were uniformly substantial as a share of GDP, there was considerable variation in the assessments of the magnitude. The findings suggested that misguided policies reduced GDP between six and eighteen percent.

Some Particulars on Biases: Among the strong and relatively common biases against SSEs is that of **agricultural policy.**[13] Widespread biases against agriculture have negative impacts on SSEs due to both input and output linkages between the agricultural and SSE sectors. When agricultural incomes decline, farmers buy less from the local SSEs for both their consumption and agricultural input needs. When there is less agricultural output, SSE incomes from processing that output are also reduced. The kinds of agriculturally-related policies believed to have these strong negative effects on farmer and, thereby, SSE incomes are as follows:

-- the pro-industry/anti-agriculture bias in trade and pricing policies, including centralized marketing and pricing;
-- the urban infrastructure bias that shortchanges rural roads, education, and health; and
-- inadequate resources for R&D in agricultural technologies.[14]

Foreign trade policy is a second set of important biases which typically undermine SSEs. More specifically, although the evidence is somewhat limited, SSEs appear to suffer from trade biases such as the following:

-- the structure of tariffs, in which large firms are more often protected than the small;
-- the structure of export incentives, whereby the small producers are unable to export the minimum necessary to benefit from the incentives; and
-- overvalued exchange rates, which reduce (a) the incentive to export, and (b) the supply of inputs for and demand for goods and services from rural non-farm enterprises.[15]

Capital markets policies also are widely believed to favor larger enterprises. Among the culprits are subsidized credit, interest rate ceilings, and tax incentives. In these cases, such policies often are not designed specifically to discriminate against the small firms. However, the latter typically cannot meet the traditionally high transaction costs of commercial banks, foreign exchange markets, and obtaining tax concessions. On the supply side, formal sector banks have often been proscribed from charging interest rates that would cover the high cost of lending to SSEs.

Even when some credit programs for small borrowers show high repayment rates, there appears to be a formal sector reluctance to extend credit to them.[16] The net result is that small enterprises rely almost exclusively on traditional credit sources, namely, family and friends. Traders, suppliers of goods, and money lenders are also involved but much less so.[17]

Although financial markets liberalization is typically included in policy reform packages, an EEPA analysis of Taiwan's financial markets suggests that financial liberalization should not automatically be considered a panacea for SSEs. Indeed, stagflation may result. Liberalization may generate higher interest rates, pull credit into the banking system and away from the curb market, and (with reserve requirements in the formal sector) contract the money supply and growth. In addition, in the imperfect capital markets of developing economies, the curb market intermediaries may have "lower transaction costs and higher investment efficiency than formal financial intermediaries." Consequently, under such financial conditions, liberalization may unduly bias financial policies toward the modern and large-scale sector.[18]

Labor Markets: Governmental labor market policies have the potential to affect the relative costs of small and large enterprises. These interventions include minimum wages, fringe benefit regulations, limitations on the recruitment and dismissal of workers, and government support for or opposition to trade unions. Assessments of the impact of such labor market policies conclude that they either have no impact on relative costs or they actually bias costs in favor of the small firms. Generally, the biases reducing SSEs' relative labor costs result from small firms either being deliberately exempted from the effect of the law or from such firms being ignored in the regulation's implementation.[19] Regional assessments, reflected in the above table, indicate that price distortions are minimal in Asia's relatively free labor markets, and rather more substantial in Africa and Latin America.

Taxes: The impact of taxes upon small and large firms is a two-edged sword. Tending to shift the relative burden more to the large firms are two realities. First, small businesses are often formally exempted from taxes. And second, even when they are not directly subject to them, smaller firms often are able to avoid payment due to their size and geographic dispersion. The large firms, however, are believed under some conditions to be able to avoid taxes. The bias in favor of the large firms comes from the fact that investment inducements often make the larger firms de facto beneficiaries of tax holidays, accelerated depreciation allowances and property tax reductions. As presented in the above table, the sparse data available suggest that the overall tax policy bias creates lower relative costs for the smaller firm, although the pattern is not ubiquitous.[20]

The "Small Firm Growth Trap," "Missing Middle," and Aggregated Effects of Policy Discontinuities: Two sets of policy influences may yield a bipolar distribution of employment by plant size. On the one hand, government policies are often so skewed in favor of large enterprises that there may be a "premature" shift of resources into large-scale capital-intensive enterprises. This shortcuts the gradual evolution of firms from small to medium and eventually to large. On the other hand, different biases create disincentives to the growth of micro and small enterprises into more modern, complex, and efficient mid-scale enterprises. This mix of policy impacts, perhaps along with other factors,[21] may create what is known as the "growth trap," the net effect of which yields a "missing middle" in the distribution of employment by enterprise scale. Such a policy trap was found to exist in three of EEPA's case studies, Honduras, Ecuador, and the Philippines, as well as in earlier USAID-sponsored analyses in India and Vietnam.[22]

Echoing a 1974 ILO report,[23] EEPA's study of policy in the Philippines noted a pattern of dualism in the manufacturing sector: "excessive bigness in firm size and business concentration," and at the small end of the scale, an economic environment supporting "the survival of an extremely large number of small and cottage producers." EEPA's report referred to several ways that the policy structure frustrates the growth of small firms into those of more efficient medium and large scale. As firms grow, they lose the advantage of government programs which support small enterprises. On top of this loss, they find that they now encounter minimum wages (a sharp "wage cliff"[24]) and sales taxes which they could previously ignore. Moreover, as the firms began to grow from a small size, they were apparently still too small to take advantage of incentives provided by the Board of Investments, incentives which were seen as basically for larger enterprises. This sharp rise in the cost structure when a firm attempts to grow beyond a small size, thus, creates the "small firm growth trap."[25]

This confluence of policies may both impede the establishment of new medium-scale firms as well as frustrate the natural evolution of successful and potentially dynamic small firms into more efficient medium-sized enterprises. The primary advantages of progressive mid-sized firms are that they tap proven entrepreneurs, reap technological, marketing, managerial and other economies of scale, and, although not researched by EEPA, may provide an industrial structure with less political volatility.[26] Accordingly, HIID and MSU urge fostering this mid-scale sector by eliminating the "missing middle" and these causal bipolar policy discontinuities.[27] The anticipated results include enhanced competitiveness, employment, income distribution, resilience to economic shocks and capricious international markets, and broad-based economic growth.[28]

A Conglomerate Emphasis' Costs? While the growth trap's injurious consequences are believed to be significant, Korea (discussed below) demonstrates dramatically that rapid growth is possible with a distinct "missing middle."[29] However, although growth and distributional successes are clear, one must also ask, first, whether alternative policies might not have led to equal or more extensive economic success, and second, whether less industrial concentration might not have resulted in less political turmoil.

POLICY REFORM PRIORITIES

There is no panacea. Standardized policy packages cannot meet all needs. Policies must be designed specifically for host country economic and political environments. Yet while considerably more research would be immensely helpful to guide policy reform,[30] comparative analysis does suggest more effective policy guidelines.

To target or bias policies? Among the issues is whether reform should "level the playing field" and eliminate all policy biases. Or, should some sectors or enterprises be targeted for support?[31] An EEPA analysis affirmed the advantage for SSEs of relatively neutral policies:

> [T]he general policy environment can be made more supportive of small producers in developing countries .... through instituting a policy environment that is at least "neutral" with respect to enterprise size.[32]

In other words, biases against SSEs should be eliminated, so that input and output markets for SSEs are as competitive as possible.

Yet research on Taiwan and South Korea suggests that there may be reasons to have some policy biases.[33] Both countries demonstrated dramatic and relatively broad-based growth. Both countries also had a number of other important common characteristics that contributed to that growth: coherent macroeconomic policies; an absence of democracy during the peak of early industrial expansion; suppressed labor movements, with competitive labor markets; and heavy investments in infrastructure and education. Moreover, both countries had a mix of neutral and targeted policies. Among their most important common targeted policies were early large scale investments, dualistic trade regimes and selective protection.

While policies appropriate for particular country conditions require country-specific analysis, there is considerable expert opinion behind one important targeting issue. Both the HIID and MSU subcontractors, as well as a recent World Bank review of small enterprises in development, argue that when supply-side interventions are planned, they should target "enterprises and industries that show high levels of efficiency and good prospects for growth of productive employment."[34] This tactic is elaborated below.

Differential Policies for "Hard" and "Soft" States: Decisions on whether, how, and how much to target may require a determination of whether the policy context is a "hard" or "soft" state.[35] A "hard state" exists where government is capable of substantial economic management without extensive bureaucratic inefficiency or leakages. The "soft state" is characterized by substantial economic mismanagement or manipulation of the public sector for private advantage. Under hard state conditions, relatively strong governmental and market institutions limit policy benefits to those firms meeting predetermined criteria. Under soft state conditions, however, attempts to direct resources to high performers will be undermined by political influence inefficiently squandering resources.

Returning to the issue of intervention versus establishing a level playing field, and the pertinence of the context being a soft or hard state, HIID's Snodgrass has posed the problem in these terms:

> It may be that few developing countries qualify as hard states for this purpose, and one is more sympathetic with the World Bank's anti-interventionist stance when one thinks about the numerous countries in which government intervention has been counterproductive than when one thinks about the few countries in which it has made a positive contribution to development. But whether countries can industrialize while keeping the playing field level is also unclear.[36]

ALTERNATIVE STRATEGIES: Two alternative hard state strategies are discussed below, illustrated by the dramatic contrast between Taiwan and South Korea. Both countries' growth is well known to have been comparatively rapid, equitably distributed, and highly successful in exports.[37] Yet Taiwan is also distinguished for the strong performance of its small and medium enterprises. In Korea, manufacturing firms tend to be larger, product markets more concentrated, and conglomerate control greater.

The Dramatic Contrast: Taiwan and South Korea Compared by Scale of Enterprise

	Taiwan	South Korea
Share of five largest conglomerates in the nation's shipments of manufactures (1982)	5%	23%
Growth in number of manufacturing firms: 1966-1976	150%	10%
50 largest firms' share: manufacturing sales, early 1980s	16%	38%

HARD STATE ALTERNATIVE I -- A SMALL AND MEDIUM SCALE EMPHASIS, THE TAIWAN MODEL: The first hard state policy strategy is an "unbalanced growth"[38] and government-induced development strategy. This model is best characterized by Taiwan, with its successful emphasis on small and medium-sized enterprises and a significant human resource/institutional base, including a strong community of experienced traders.

On Policy Targeting: Taiwan's economic policy was not a perfectly "level playing field". As was true for Korea, Taiwan had a dualistic trade regime: low overall trade barriers, substantial variation across economic sectors, and high subsidies for consumer durables and higher levels for fabrication. A fundamental difference from Korea was that in financial markets, Taiwan did not have the artificial state-created financial economies and, in fact, had financial diseconomies for large-scale enterprises.

This government-induced development strategy initiates vigorous growth with strategic industrial interventions, sometimes manifest in the establishment of large scale enterprises. These interventions create externalities, profitable opportunities, that induce the entry of firms responding to those entry-inducing externalities. This subsequent entry includes the proliferation of small and medium enterprises, with consequent expanded competition and transactional efficiency.

Large Firms' Potential Inducing Role in SME Development: In Taiwan, large firms, and in the early stages, public enterprises, played a very important role in the growth-"inducing interventions" of Taiwan's government. During the 1950s in Taiwan,

> more than half of indust ial production came from public enterprises .... As the projects got bigger and more technologically advanced, government en ered into joint ventures with foreign multinationals. In this way, the basis was laid for production of petrochemicals, plastics, artificial fiber, glass, cement, fertilizers, plywood, textiles and many other products.... Even today, Taiwan's upstream industries tend to be highly concentrated and dominated by public enterprises.

This government-induced growth of large firms in Taiwan had a variety of linkages with the small and medium scale sector.

Large/Small-Scale Linkages: One important manifestation of the large/small scale linkages was the stimulus of the newly attracted multinationals with strategic technological lines.[39] The presence of these new technologies enabled their imitation by smaller local producers. This local replication took place via word of mouth, labor migration, and supplier operations. Another large to small linkage in Taiwan was the substantial proliferation of subcontracting, linking the large firms closely to the small in a way true also in Japan but not in Korea.[40] Further, large Taiwanese firms also supported the major role of SMEs by being a source of trained craftsmen who later became entrepreneurs (a practice facilitated by its vigorous informal credit market[41]). Credit was still another important large to small firm linkage in Taiwan. Whereas larger firms typically had access to formal credit markets, the small did not. Accordingly, product subcontracting was often accompanied by a parallel flow of credit from the large to the small.[42]

Other SME-Supportive Interventions: A variety of other economic and social policies and investments served to induce the emergence of Taiwan's dynamic small and medium scale sector. In the more traditional economic vein, the Taiwanese policy mix included:

> investment incentives, tax laws, labor laws (and their weak enforcement), and a host of other policies (business licensing procedures, antitrust laws, bankruptcy laws, export quota management) presented strong incentives (though often unintended by the authorities) to limit company size.[43]

Notably, what they did not use were South Korea's massive financial interventions and incentives. Among the social interventions were those to relieve bottlenecks in "education, health, public utilities and pollution."

Finally, to assure gains in productivity and international competitiveness, the Taiwanese implemented numerous technological development policies. These included R&D centers, technical libraries for business, subsidized foreign travel to equipment shows and factories, quality education (with strong science and engineering programs), efficient skill training (closely linked to industrial demand), foreign technical licensing agreements (with possible government involvement in their negotiation) and collaboration with multinationals. Overall, these policies complemented the large-scale enterprise interventions and avoided creating a growth trap or "missing middle" in the array of firms by scale.

<u>HARD STATE ALTERNATIVE II -- A CONGLOMERATE EMPHASIS, THE SOUTH KOREAN MODEL</u>: EEPA's other hard-state strategy emphasizes large scale enterprises and is referred to as a "government-directed learning" strategy. This model has two principal tasks: "picking winners" and developing policy instruments that induce entry, growth and productivity increases among firms with substantial potential for dynamic internal economies. An emphasis on conglomerates enables:

> the capture of simultaneous externalities, in part by enabling large individual enterprises by virtue of their size and associated diversification to internalize externalities, in part by facilitating co-ordination among a small number of large enterprises, co-ordination that would be exceedingly difficult to achieve in a more diffuse industrial structure.

Yet, because the capture of economies is due to administrative determination of major investment decisions and a less competitive domestic environment, there are fewer pressures to enhance the long-term advantages that come from the improved "transactional efficiency of markets." In Korea's case, however, the capture of externalities through vertical integration eliminated the subcontracting from large to small that was so widespread in Taiwan.

On Policy Targeting: Like Taiwan, some of South Korea's policies were of the neoclassic level playing field variety. These included the move from a multiple to a uniform exchange rate and rebates of indirect sales taxes and import duties to all exporters meeting performance criteria. In 1968, these nondiscriminatory policies were so substantial in impact that they amounted to nearly 30 percent of the value of merchandise exports.

Other policies, however, were heavily biased toward selected sectors (notably successful exporters) and large enterprises. These biases included infant industry protection, tax exemptions, long-term credit (100% controlled) at sub-market interest rates, and assistance in marketing through the organization of huge conglomerates. The potential for misuse of such instruments was considerable. In the allocation of long-term credit and tax breaks, the criteria for their distribution left substantial discretion with the bureaucracy and a high degree of uncertainty on behalf of the applicant. Apparent additional rewards to successful exporters included continued government support and facility in their dealings with the bureaucracy. Even the rigor of tax collection was determined by export performance.

That Korea's conglomerates overwhelmed its SME sector appears due both to Korea's more limited early entrepreneurial and human resource base,[44] and the broad array of large scale policy biases which helped compensate for that early human resource and institutional weakness. In other words, given Korea's initial conditions, Korean policies promoting industrial concentration may have been an "efficient response to backwardness" in its human resources base.

The costs of a Korean-type strategy, however, are the risks of both miscalculation in identifying profitable sectors as well as "rent-seeking ... and socially unproductive policies." However, these may be necessary risks when a human capital, entrepreneurial, and institutional base approximating Taiwan's does not exist. Without the core of a healthy trading community, a SME-based strategy may be more problematic.

<u>FOR THE "SOFT STATE"</u>: Where government's administrative capability is more limited, correspondingly modest levels of intervention may be appropriate, to avoid the leakage of administered resources out of the country (e.g., into Swiss banks) or into other unproductive activities. Because a relatively pure laissez-faire strategy is not known to have been effective outside of Hong Kong (a virtually unique political and economic environment), a mixture of laissez-faire and hard state strategies is proposed for soft states. Policy formulation for these soft states, then, should "minimize discretion by government officials" and include serious consideration of the following tactics:

-- efficient markets and competition, including minimizing administrative and legal barriers to establishing new businesses;

-- "performance-based" support for progressive small and medium enterprises (rather than micro or large enterprises),[45] including through the means of vigorous informal financial markets;[46] and

-- export promotion, including through the means of:
  ** guaranteeing working capital for exports;
  ** incentives to stimulate the proliferation of export traders;
  ** selective involvement of multinationals as exporters; and
  ** selective and firm-specific incentives for national exporters of manufactures.

In countries where there are also substantial price distortions, EEPA has recommended a variety of further options:

Export processing zones, tariff drawback schemes for direct and indirect exporters, bonded warehousing programs and the like are additional mechanisms for promoting exporters by affording tariff-free access to otherwise protected inputs, mechanisms that have no attraction in already undistorted price environments. But they are exceedingly attractive options in soft states riddled with distortions, where the objective is the roundabout one of working to strengthen the hand of interests favoring reform. It was evident to us in our work in the Philippines that, for all of the shortfalls in implementation, export processing zones, tariff drawback schemes, and bonded warehouses were crucial in enabling manufactures to take root; and these exporters were in late 1986 among the most vociferous advocates of continuing policy reform. Indeed, it was Korea and Taiwan that pioneered the use of zones, drawbacks and the like in the early 1960s.

The extent to which exports should be promoted depends on considerations such as a country's resource and institutional base and potentials for efficient import substitution and for economies of scale in domestic markets.

<u>THE AFRICAN CASE</u>: Because of Sub-Saharan Africa's profound developmental difficulties, EEPA developed policy guidelines for the region.[47] Africa's diversity,[48] however, dictates that these must be used only with due consideration for the specifics of the local socio-economic environment. Yet Africa has its own distinguishing characteristics: very low incomes; low population density; poor infrastructure; falling agricultural output per capita; and underdeveloped human capital.[49] African small enterprises also have their own distinguishing features, being numerous, widespread, primarily rural, and overwhelmingly small (generally, a one-person household-based enterprise).[50]

With this setting for and pattern of African SSEs, the objective of the proposed reforms is a policy, institutional,and infrastructure environment conducive to overall growth, and thereby to expanding employment opportunities in efficient and dynamic enterprises.[51] Accordingly, EEPA suggests the following **highlights of a strategy for Africa:**

** **Agricultural policies consistent with efficient and broad-based growth are a crucial priority.** Particularly important are enhanced agricultural research and development and the elimination of urban bias in national developmental policies. As the sector is the major source of income for the rural majority, Africa's widespread rural small enterprises are heavily dependent on the health of this primary sector for their own survival and expansion, as discussed above.

** **Liberalized foreign trade policies -- foreign exchange markets, tariffs, licenses, and export promotion policies -- are particularly important**, for the following reasons:

- -- Africa's growth is particularly dependent on foreign trade, yet basic restructuring of inefficient administered trade regimes is relatively rare;
- -- Trade policy reform, in most of Africa, constitutes the single most potent means to overcome governmental decision-making that is particularly biased against SSEs; and

-- Trade can make a substantial contribution to overcoming small domestic markets, thereby enabling some economies of scale, induced competition and efficiency, and more labor-intensive growth.

Yet -- as considered in the above discussions of the level playing field and the hard/soft states -- while it is vital to liberalize markets, there may be circumstances where infant industry protection or export incentives are appropriate.

** **Small entrepreneurs nearly always identify credit as their primary need. To ease the extent to which credit is a constraint, a number of alternative financial tactics for small and medium firms are worthy of consideration.** These include character-based lending, easing administrative processing of loan requests, and expanding the flow of credit to SMEs through commercial banks.[52]

** Although SSEs typically pay lower taxes than their larger counterparts, in some countries firms encounter "growth trap"-like difficulties as they attempt to grow and innovate.[53] **A promising approach to fiscal reform appears to be one tried in a number of African countries: special studies of the tax system, combined with collaboration among government, business officials, and organizations working directly with producers.**

** With regard to **human resources priorities**, EEPA's research is inconclusive. However, to enable small firms' entrepreneurs to respond better to their market signals, and to undercut the problems inherent in widespread labor force illiteracy, EEPA has supported **increased spending on secondary education, a redirection of the educational system toward entrepreneurial skills, and a reorientation of vocational training to focus on basic skills in demand.**

** **Collaboration in the reform of legal and administrative systems also is essential.** Inefficient legal and regulatory systems constrain particularly the larger enterprises, although large scale/small scale market interactions imply a derivative burden on the small as well. While a number of reforms have already been undertaken, implementation appears to be lagging seriously behind the mandate.

<u>POLICY REFORM TACTICS</u>: Policy reform supporting a more efficient industrial structure is most effectively pursued through collaborative donor/host country policy dialogue and analysis.[54] With such involvement host country decision-makers build their own analytical capability, understanding of alternative policy impacts, and sense of ownership of the proposed reforms. Appropriate tactics for such an approach include strengthening both host country and donor policy analysis programs, including personnel, data, and analytical resources. The priority for such programs should not be underestimated, for their thoughtful implementation may substantially enhance industrial transformation, employment, and social cohesion.

ENDNOTES

1. U.S. Department of Labor (USDOL), on loan to the U.S. Agency for International Development (USAID). Being a review article, the author is, of course, heavily indebted to EEPA's researchers and other cited authors. Particular appreciation is also extended to Michael Farbman and Catherine Gordon (USAID), Carl Liedholm (Michigan State University), Elizabeth Rhyne (also USAID/USDOL), and Donald Snodgrass (Harvard Institute for International Development) for highly constructive comments on various drafts. The author alone, however, is responsible for any errors of interpretation, commission, or omission. Opinions expressed in this article, other than those drawn from EEPA or other referenced material, are the author's and are not intended to represent those of either USAID or USDOL. A full EEPA bibliography is available from the author in care of USAID/PRE/SMIE; Washington, D.C. 20523; USA.

2. There is no commonly agreed worldwide estimate of employment in small enterprises. Yet, pursuing a partial estimate -- with a definition not exclusively based on scale but generally referring to "very small scale", largely independent and self-employed owners, with very little capital, few employees, and low levels of technology and productivity -- in early 1991 the ILO estimated that 300 million are employed in the urban informal sector. [ILO, The Dilemma of the Informal Sector, 1991, p. 11] Obviously, this does not include those employed in the numerous rural small enterprises. In the manufacturing sector, there is considerable evidence that in the poorer countries the "vast majority are located in the rural areas." [Carl Liedholm and Donald Mead, Small Scale Industries in Developing Countries: Empirical Evidence and Policy Implications, Michigan State University International Development Paper No. 9, 1987, p. 18] Accordingly, if one assumes that employment in urban small enterprises is only one-third to one-half of total small enterprise employment, then (a) adding rural SSE employment to ILO's rural estimate, and (b) expanding the definition to include small firms as well as ILO's above estimate for the "very small" category, total developing country small enterprise employment may be roughed out as somewhere in the neighborhood of one billion. It should be noted here that definitions of small, micro, informal, cottage, etc. enterprises are highly diverse in the literature. For the purpose of this report, "microenterprise" will generally refer to a firm with up to 10 workers, and "small" to up to 50. "Informal" will be used to refer to roughly the same grouping as "small".

3 Philip A. Neck (ed.), Small Enterprise Development: Policies and Programs (Geneva: International Labor Organisation; 1977), p. 13. Presumably the author is referring here basically to non-farm options, for the great majority of less industrialised workers are still employed overwhelmingly in agriculture. In 1980, the World Bank reports, 72% of the labor forces of low-income countries were employed in agriculture. World Development Report: 1987 (Washington) p. 264.

4. With regard to their role in modern economies, Dun and Bradstreet ("Comments on the Economy" April/May 1991) estimated that the "lion's share" (57%) of employment growth in the American economy in 1991 will come from firms with fewer than 100 workers, although smaller firms were more pessimistic about the prospects for compensation increases. It should be noted, however, that this D&B definition is substantially more inclusive (i.e., up to 99 workers, rather that the 49 workers used in most of the EEPA reports.

5. Malcolm Gillis, Dwight H. Perkins, Michael Roemer, and Donald R. Snodgrass, Economics of Development, second edition (New York: Norton; 1987) p. 561.

6. For example, a 1974 ILO report (the [Gustav] Ranis report): "[A] bias toward large-scale manufacturing was enhanced by the policies of incentives adopted by the Government [of the Philippines] in the 1950s and 1960s." ILO, Sharing in Development: A Programme of Employment, Equity and Growth for the Philippines (Geneva, ILO, 1974). See also the discussion of the importance of policy for project success in W. Donald Bowles, "A.I.D.'s Experience with Selected Employment Generation Projects", A.I.D. Evaluation Special Study No. 53, March 1988. While Bowles mentions the importance of policy, he also strikes a chord somewhat similar to that of Vernon W. Ruttan: "The removal of distortions in monetary, fiscal, trade, commodity, and consumer policy does not produce development. Policy reform is, in some countries, a necessary condition for development.... But the real sources of economic growth are investments in human and physical capital and in productivity-enhancing technical and institutional change." From Ruttan's, "Solving the Foreign Aid Vision Thing", Challenge (May-June 1991).

7. State Department cable: Paris 37936, December 20, 1990.

8. For background on A.I.D.'s small enterprise research, see, A.I.D., Experiments in Small- and Microenterprise Development, A.I.D. Science and Technology in Development Series (n.d.[1991]).

9. This sector appears to invariably accompany any successful increase in status from a low- to high-income country. While services too are clearly important in the industrial transformation, for they also increase in relative importance, research appears to demonstrate their dependence on manufacturing, rather than vice versa.

10. For related research, discussing the complex relationship between scale and efficiency, see: Liedholm and Mead; Tyler Biggs and Jeremy Oppenheim, "What Drives the Size Distribution of Firms in Developing Countries?" EEPA Discussion Paper No. 6, November 1986; Ian M.D. Little, Dipak Mazumdar, and John M. Page, Jr., Small Manufacturing Enterprises: A Comparative Analysis of India and Other Economies (New York: Oxford; 1987), p. 305; Mariluz Cortes, Albert Berry, and Ashfaq Ishaq, Success in Small and Medium-Scale Enterprises: The Evidence from Colombia (New York: World Bank; 1987), p. 209+. pp. 6+. For an interesting critique of the first of these by an EEPA analyst, see Donald C. Mead, "Review Article: Small Enterprises and Development," Economic Development and Cultural Change, January 1991.

11. Haggblade, Liedholm and Mead.

12. See Snodgrass, DEVRES Workshop paper, and Little, Mazumdar, and Page.

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13. On the importance of a sound agricultural policy for broad-based development and SSEs, see Hans Binswanger, "Agricultural Growth and Rural Nonfarm Activities, Finance and Development, June 1983, and the Mellor and Adelman articles in John P. Lewis and Valeriana Kallab (eds.), Development Strategies Reconsidered (New Brunswick: Transaction Books, for the Overseas Development Council; 1986)); and Irma Adelman, "Beyond Export-Led Growth", World Development, Vol. 12, No. 9, 1984. For a more detailed discussions of agriculture, off-farm employment, and rural labor markets, see Joel Greer and Erik Thorbecke, Food Poverty and Consumption Patterns in Kenya (Geneva: ILO; 1986), and Steven Haggblade and Carl Liedholm, "Agriculture, Rural Labor Markets, and the Evolution of the Rural Nonfarm Economy," GEMINI Working Paper No. 19 (Bethesda, MD: Development Alternatives, Inc , for USAID/APRE/SMIE; May 1991.

14. See: Haggblade and others, EEPA #1; Peter Kilby and Carl Liedholm, "The Role of Nonfarm Activities in the Rural Economy", EEPA #7, November 1986, also published in J.G Williamson and V R Panchamukhi (eds) The Balance between Industry and Agriculture in Economic Development, proceedings of the Eighth World Congress of the International Economic Association, Delhi, India (MacMillan; 1989); Steven Haggblade and Peter Hazell, "Agricultural Technology and Farm-Nonfarm Growth Linkages," Agricultural Economics 3 (1989); Steven Haggblade, Peter Hazell, and James Brown, "Farm-Non Farm Linkages in Rural Sub-Saharan Africa", World Development, Vol 17, No. 8, 1989; and UNDP, Government of the Netherlands, ILO, and UNIDO, Development of Rural Small Industrial Enterprise: Lessons from Experience (Vienna: 1988)

15. Unfortunately, overvalued exchange rates have a particularly insidious effect of raising the cost of input supplies in the notable case of farmers, who often have a significant potential but frustrated actual achievement in agricultural exports. See: Haggblade et al , EEPA #1; Liedholm and Mead, Ch IV; and UNDP et al.

16. Jean-Jacques Deschamps and William Grant, with Albert Berry and Susan Goldmark, "The Impact of Financial Market Policies: A Review of the Literature and the Empirical Evidence", EEPA #21, October 1988; and Haggblade et al., EEPA #1.

17. Formal money market sources generally account for less than one percent of small business start-up capital.

18. Tyler S. Biggs, EEPA #s 15 and #16 (rev), summarized in "HIID Research Review", Winter 1989.

19. Haggblade et al., EEPA #1, pp. 13-17; Liedholm and Mead, pp. 93-94; and Snodgrass, 1991, p. 14.

20. Snodgrass, in a letter to the author (10Oct91), noted that his counterpart in Indonesia is finding that "even the smallest firms are tracked down by the tax men and regulators, and moreover that compliance with the rules and regulations reduces their return on capital more than it does for the larger firms." See also, Haggblade et al., #1, pp. 29-32; Liedholm and Mead, pp. 95-96; and Snodgrass, 1991, p. 32.

21. There is uncertainty about the extent to which other factors may contribute to this gap, or dip in the distribution of employment by enterprise scale. Such factors might include resource constraints (human, capital, or technological) on the small, economies of scale (e.g., in marketing, management, or technology), access to substantial amounts of capital by elites, or the fact that importing technology through multinationals often comes in large packages.

22. See, Susan Goldmark, Jean-Jacques Deschamps, William Glade, Maria Willumsen, with Maria Concepcion Lopez and Ana Cristina Mejia, "The Effect of Policy Upon Small Industry Development in Honduras", EEPA Technical Cooperation Report, September 1987; Lehman B. Fletcher, Gustavo A. Marquez, and David E. Sarfaty, "Formulating a Strategy for Employment Generation in Ecuador: Issues and Priorities", November 1988; Tom Timberg, "Report on the Survey of Small-Scale Industry Units in Bombay", World Bank Economic Development Department, 1978; and Clifton Barton, "Credit and Commercial Control: Strategies and Methods of Chinese Business in South Vietnam", Ph.D. dissertation (Cornell University, 1977), both quoted in Carl Liedholm, "The Dynamics of Small-Scale Industry in Africa and the Role of Policy", GEMINI Working Paper, No. 2 (co-funded by EEPA) January 1990, p 40; and Tyler Biggs, Brian Levy, Jeremy Oppenheim, and Hubert Schmitz, with assistance from the Philippine Center for Research and Communication (CRC), "The Small Business Policy Direction Study", for the Ministry of Trade and Industry, Republic of the Philippines (n.d. [1987]), pp. 26+. See also the discussion in Biggs, Grindle, and Snodgrass, EEPA #14, pp. 48+.

EEPA's review of policies in Africa reflects a weak data base and doubt about the presence of a strong policy growth trap there. EEPA, nevertheless, expresses concern that "careful attention must be paid to avoiding sharply negative policy discontinuities that would act as a disincentive to firm expansion" into "modern small and medium-sized firms." Liedholm, GEMINI Working Paper #2, pp. 40 & 46.

23. The Philippine's "missing middle" was examined more than a dozen years earlier by a distinguished team headed by Gustav Ranis, which noted "the distribution of manufacturing employment in the Philippines ... is unusual in its concentration in the very small and the very large establishments " ILO, Sharing in Development: A Programme of Employment, Equity and Growth for the Philippines (Geneva; 1974), pp. 141 and 158

24. The Little, Mazumdar, and Page survey, Small Manufacturing Enterprises, reported substantial "wage cliffs" in India and Indonesia, and smaller ones in Colombia and Malaysia. The sharp rises in wages, respectively, began in the range of 100-200 workers for India and after 200 workers in Indonesia. The wage increases in developed countries associated with scale exist but "are small compared with those in any developing country." Moreover, they argue, "[i]t cannot be lightly assumed that the wage differentials which exist after allowing for skill differences must be distortions that are caused by union activity or government intervention." (P. 310)

25. See, Biggs, Grindle, and Snodgrass, pp. 51, Biggs et al , "Small Business Policy Direction Study", pp 33+, and Snodgrass' DEVRES workshop paper, p. 14. -- It should be noted that a dualistic pattern of distribution of industrial employment by enterprise scale is not fatal, for South Korea is a dramatic illustration of a country with a substantial missing middle which has not been seriously impeded by not having the smooth curve skewed to the right (lognormal) characteristic of the U S , UK, and Germany. The basic argument, however, is that industrialization without the scale dualism is a more efficient pattern than one without For a selection of such graphs, see Biggs and Oppenheim, EEPA #6, pp. 7+

26. Although not researched by EEPA, there is also a political advantage to having a healthy mid-sized set of enterprises, as opposed to a dominating set of conglomerates. London's Economist (23Sept89; p. 39): In the light of South Korea's industry being dominated by a relatively small number of big firms, "South Korea's technocrats ... are now intensely worried about [a] lack of internal competition." Moreover, the Economist reports, "business affairs are mingling dangerously with politics .... [and the] government has given the economy some problems that could prove difficult to solve " Larry E. Westphal has also referred to the fact that Korea's "highly concentrated industrial structure ... is unpalatable to many Koreans." Journal of Economic Perspectives, Summer 1990.

27. See, for example, Snodgrass, DEVRES, p. 14; Biggs and others, "The Small Business Policy Directions Study [Philippines]"; Liedholm, GEMINI Working Paper #2, pp. 40 & 42; and Mead (EEPA #26, pp. 7-9 & 15).

28. Biggs, Snodgrass, and Grindle, pp. 52-59.

29. See the curve in Biggs and Oppenheim, EEPA #6.

30 See, for example, the economic and political research priorities discussed by Gustav Ranis, Henry Bruton, Gary Fields, and Stephan Haggard, in DEVRES, Inc., "Policy Reform for Broad-Based Growth: A Research Workshop [9Nov90] -- Final Report", submitted to the Office for Small, Micro, and Informal Enterprises, Bureau for Asia and Private Enterprise, U.S.A.I.D., May 1991.

31. Snodgrass (DEVRES, 1991) refers to the "World Bank and many economists" favoring the "level playing field", and Kieth Marsden's "Creating the Right Environment for Small Firms", is a good example: "In conclusion, the best environment for small firms is a relatively free market that provides equal incentive and opportunity for all enterprises." Finance and Development (December 1981). A more recent World Bank conference illustrated the substantial set of opinions that there is not one policy route to development. "Roundtable Discussion -- Development Strategies: the Roles of the State and the Private Sector," Proceedings of the World Bank Annual Conference on Development Economics (1991).

32. Liedholm and Mead, p. 122.

33. See: Biggs, Grindle and Snodgrass; Biggs, EEPA #s 15, 16, & 17; Tyler Biggs and Chang-Ho Yoon, EEPA #27. The Korean experience suggesting the importance of policy bias in generating growth is also discussed by Larry E. Westphal in the Journal of Economic Perspectives (June 1990): "In sum, micro empirical research done over the past 15 years, some of it in Korea, suggests a strong theoretical case in favor of selective intervention to promote infant industries in less developed countries." Further, he notes that the non-neutral policies used to support infant industries were, most importantly, import protection, but also important were "preferential access to ... credit", "reductions or exemptions with respect to most or all direct and indirect taxes (including tariffs)", and the selective molding or creating of marketing agents in the form of chaebol, "extremely large conglomerate groups whose activities span all sectors but are concentrated in manufacturing and construction." The Taiwanese case is a happy contrast in that it also represents an approach to rapid growth, but without the same high degree of governmental intervention and industrial concentration found in Korea. See also, Colin I. Bradford, Jr., "East Asian Models: Myths and Lessons", in J.P. Lewis and V. Kallab (eds.), Development Strategies Reconsidered (New Brunswick: Transaction Books; 1986).

34. Mead, "Review Article...," p. 413. Also, Snodgrass, DEVRES Workshop paper; and Little, Mazumdar, and Page, p. 313.

35. EEPA (Snodgrass, DEVRES, 1991, p. 15) acknowledges the early development of the "soft state" concept by Gunnar Myrdal, in his Asian Drama: An Inquiry into the Poverty of Nations (New York: Pantheon; 1968).

36. Snodgrass, in DEVRES Workshop paper, p. 15. One should not equate "soft" and "hard" states with developmentally virtuous and otherwise. One thoughtful analyst: "... I would ... argue that some of the criticisms of the 'softness' of the state, and the corollary view (characteristic of early writings on development economics) that the 'harder' the state the more effective it must be, are dead wrong. Quite often what appears as softness is the responsiveness of the state to the public asserting itself and demanding that the state should take heed of the public's welfare. That need be no bad thing." Amartya Sen, "Roundtable Discussion -- Development Strategies: The Roles of the State and the Private Sector", Proceedings of the World Bank Annual Conference on Development Economics, 1990, p. 425

37. "Between 1965 and 1983, GNP per capita grew at an average annual rate of 6.5 in Taiwan, and 6.7 percent in Korea, as compared with an average rate of 3.8 percent for a larger sample of upper-middle-income less developed nations. Gini coefficients for After-tax household income amounted to .285 (in 1978) and .389 (in 1980) for Korea and Taiwan respectively, placing both nations in the low-inequality group of countries. Interestingly (and consistent with our analysis of differences between the two countries), between the late 1960s and late 1970s inequality widened in Korea but narrowed in Taiwan." Tyler S. Biggs and Brian Levy, EEPA #23, pp. 10. Much of the following discussion of Taiwan and South Korea comes from this paper.

38. Biggs and Levy acknowledge an indebtedness to Albert O. Hirschman's The Strategy of Economic Development (Yale; 1958).

39. "In the early 1960s, ... textiles and sewing machines, later on .. secondary import-substitution industries and electronics." Biggs and Levy, pp. 33-34.

40. Biggs and Levy, EEPA #23, p. 24; and Liedholm and Mead, pp. 56-58.

41. Biggs, EEPA #16 (rev.), p. 21.

42. Tyler S. Biggs, EEPA #16(rev), August 1989, p. 13. Bolnick's financial sector analysis in Malawi indicated that, contrary to the Taiwan case, "Supplier trade credit is 'extremely difficult' for SMEs to get, according to available evidence." Donald C. Mead, Bruce R. Bolnick, and Robert C Young, "Strategies for Small and Medium Enterprises in Malawi", EEPA Technical Assistance Report, August 3, 1989, Annex IV, p. 61.

43. Biggs and Levy, EEPA #23, p. 32-33. Incidentally, corporate combined with personal income taxes do not appear to have seriously damaged the economy. The maximum corporate rate was 25% before 1974 and 35% after, while the personal income tax rate, relatively high compared to current American rates, were 50% before 1969 and 60% after.

44. See Brian Levy, "Export Intermediation and the Structure of Industry in Korea and Taiwan", EEPA #13, October 1987, and his "The Strategic Orientations of Firms and the Performance of Korea and Taiwan in Frontier Industries: Lessons from the Comparative Case Studies of Keyboard and Personal Computer Assembly", EEPA #12, October 1987.

45. Snodgrass, in DEVRES' Workshop: "We asked ourselves why government intervention apparently helped in [Taiwan and South Korea] while it has been demonstrably harmful in India and many other countries A big part of the answer is that intervention in Korea and Taiwan was generally performance-based Assistance was not given automatically to firms just because they were small Instead, it was made strictly conditional on performance, particularly in the export market, and withdrawn when the desired level of performance did not materialize." In a letter to the author (1Oct91), Snodgrass elaborated on performance-based interventions: "Sure, one should concentrate on firms and industries with good growth prospects, but can these be identified accurately in advance? The EEPA view is that while it is impossible to 'pick winners' in advance one should offer performance-based incentives to promising producers, then withdraw them from non-performers. However, Wade says countries must 'make winners,' not 'pick' them. That is, they must decide what industries they wish to establish, then do whatever is necessary to make them succeed."

46. In Taiwan little domestic credit flowed through specialized banks to SMEs, and most of that which did went as working capital for medium-sized exporters. There were no SSE credit programs designed to boost the sector, apart from a small number of government credit guarantees. Biggs, EEPA #16 (rev.), p. 1. -- The most important informal or curb market instrument was the post-dated check, which was usually used to facilitate trade credit between firms Because this credit was so important (roughly 30-80 percent of private business credit, depending on the size of the firm), in the 1950s, to support this market government criminalized failure to honor such checks, and in 1985 granted prominent enterprises a "six month grace period for redeeming bad checks (read post-dated checks). ." Small and Medium Business Assistance Center, "Financial and Management Services to Small/Medium Business in Taiwan, the R.O.C.," Annual Report, 1985, quoted in Biggs, p. 14. In 1987, following a financial scandal involving the curb market, to reduce the prevalence of post-dated checks, "the criminal penalty for issuing bad checks was abolished " Biggs, p. 17.

47. Much of the following discussion of African policy priorities is from Donald C. Mead, EEPA #26, and Liedholm and Parker, EEPA #25. More detailed reports on Africa and other cases in Latin America are also available.

48. Illustrating the diversity, Botswana and the Congo have per capita incomes five times those of Burkina Faso and Zaire, and the rural population densities of Rwanda and Malawi are more than 10 times those of Cote d'Ivoire and Zimbabwe.

49. For the 12 African countries, the maternal mortality rate is higher than 500 for every 100,000 live births, versus 44 in China and 90 in Sri Lanka. World Bank, Sub-Saharan Africa: From Crisis to Sustainable Growth (Washington: 1989) p. 65

50. Within the manufacturing sector, the sectoral composition is primarily light manufacturing, with a recent shift from traditional to more modern commodities, such as from weaving and traditional mats to tailoring and modern furniture. Moreover, contrary to some casual impressions, the majority of modern small and medium scale enterprises do not appear to have had microenterprise origins but started out with more than 10 employees. Finally, economic efficiency tends to be higher for those small firms which are: somewhat larger, on average being positive only for firms of more than one worker; operated away from the home; produce more modern commodities, such as baking, tailoring, carpentry, metal-working; and located in the larger, more urbanized, localities. Liedholm and Parker, p. 26.

51. While the problem is too complex to analyze and confirm definitively under all circumstances, there is general consensus within EEPA that a sound set of efficient growth policies can be consistent with the efficient development and growth of the small and medium enterprise sectors: "...the policy environment which supports the growth of progressive small and medium enterprises is desirable on other grounds, since it happens to be one which is also conducive to efficient industrial growth and structural transformation." Biggs, Snodgrass, and Grindle (EEPA #14), p. 8(

52. Mead suggests that credit does not appear to be the binding constraint on African small enterprises. More important, he argues, are the small markets in which they sell and limited information about potential new products, technologies, skills and markets. See, Donald C. Mead, EEPA #26, pp 13-14, Augustin Ngirabatware, Leonidas Murembya and Donald Mead, "Medium and Large Manufacturing Firms in Rwanda: Diagnostic Study of Current Situation and Policy Impact", EEPA #22, August 1988; and Mead, Bolnick, and Young. Similarly, Snodgrass also expresses skepticism: "We know that small firms rely mainly on their own savings to finance their investment and borrow very little, especially from banks. What is less clear is how much this impedes their growth. I am not impressed by the fact that many small businessmen cite difficulty in obtaining capital as one of their main problems. When credit is subsidized, and therefore rationed, this may represent nothing more than a desire to get in on the bounty." [His letter to author, 1Oct91]

53. Liedholm, GEMINI #2, p. 40.

54. Haggblade, Liedholm, and Mead, EEPA #1; but see also: Patricia Vondal, "Operational Issues in Developing A.I.D. Policy Reform Programs" A.I D. Program Evaluation Discussion Paper No 28 (USAID/CDIE: October 1989), pp. 24-28; Sidney Weintraub, "Policy-Based Assistance: A Historical Perspective", paper prepared for discussion with A.I.D./Washington, July 20, 1989; and Donald R Snodgrass and others, "The Use of Program Loans to Influence Policy", A.I.D. Evaluation Paper 1A, Part 1, March 1970, p 41.

EEPA's staff and others have experienced the effectiveness of this collaborative approach. In one instance, after a collaborative donor/host country team's careful analysis of rural small enterprises, the host country indicated that subsequently such firms would be one of their developmental priorities Following another collaborative advisory experience, the host country relaxed some price controls, revised its investment code to give SMEs more favorable treatment, commented that this project was unique among donors in not giving the country fish but instead in teaching it how to fish, and later promoted the host country collaborator to be Minister of Plan.

Trade Shocks in Developing Countries: Consequences and Policy Responses

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TRADE SHOCKS IN DEVELOPING COUNTRIES: CONSEQUENCES AND POLICY RESPONSES

David Bevan, Paul Collier and Jan Willem Gunning[1]

Introduction

Many of the poorer developing countries depend for their export earnings on a narrow range of commodities. Commodity prices have been highly volatile and price changes tend to be asymmetric. The typical pattern is for short, sharp peaks to be interspersed by long, shallow troughs (Deaton and Laroque, 1992). Price peaks are quite often recognised as temporary: the cotton boom of the 1860s, the oil boom of 1990, and the coffee, tea and cocoa booms of the 1970s were of this form. Price crashes are usually associated with ruptures in cartels which are also often temporary; recent examples are diamonds (1981), oil (1986) and tin (1986). How should governments respond to external shocks if volatility of world prices is taken as given (i e. abstracting from international price stabilisation schemes)? This is an important issue since policies in response to shocks have typically been misguided and the consequences have been costly. For example, the temporary oil boom triggered by the Iraqi invasion of Kuwait momentarily improved Nigerian public finances, but during 1991 a serious fiscal crisis developed.

By the time of the beverage booms of the late 1970s (coffee, tea, cocoa), there was a clear consensus on the desirability of stabilising taxation and the World Bank had helped to install stabilising export taxes in most developing countries. The consensus was based in part on the belief that the private sector (particularly in the case of poor, illiterate farmers) was unlikely to respond appropriately to temporary shocks. booms would be squandered rather than saved. In this paper we first summarize earlier research on the Kenyan coffee boom and then present preliminary results of a comparative study of trade shocks in sixteen developing countries.[2]

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[2]This study on "Temporary Trade Shocks in Developing Countries" is partly financed by the World Bank, the Institute of Energy Studies and the International Center of Economic Growth and the usual disclaimer applies. The countries covered are: Bolivia, Botswana, Cameroon, Colombia, Costa Rica, Côte d'Ivoire, Egypt, Ghana, Indonesia, Malawi, Mexico, Niger, Nigeria, Senegal, Venezuela and Zambia. In the country studies the effects of trade shocks were derived from a comparison of

The Kenyan Coffee Boom

The case of the Kenyan coffee boom of 1976-79 (Bevan et al., 1989, 1990) is of particular interest because the Kenyan government rejected the advice to stabilise, passing the price increase on to farmers. The boom was caused by a frost in Brazil which damaged but did not destroy the tree stock so that the resulting fourfold increase in the coffee price was clearly temporary. Kenyan coffee farmers had never experienced such a price shock. From a purpose-designed survey of 800 rural households we found that coffee farmers had a windfall savings rate of around 70%[3]. Thus, in the Kenyan case, fears that private agents would not save a windfall proved entirely misplaced.

Since most developing countries are short of capital (meaning that they have a higher return on it than in developed countries), there is a presumption that the best strategy is to invest windfall savings domestically. Investment usually requires non-tradables (such as construction activities and management services for investment opportunities to be identified and realised) so that increasing investment very quickly may lead to cost increases which can be avoided by smoothing investment. Hence the optimal strategy is likely to be to stretch the investment boom over a longer period than the savings boom by holding windfall savings temporarily as foreign assets.

In Kenya private agents could not legally acquire foreign assets because of exchange controls. Their choice was between real assets and domestic financial assets. In aggregate, the only domestic financial asset available to the private sector is a claim on the government and in Kenya this essentially meant base money since government loans were minor. This reduced the incentive for private agents to hold financial assets and thereby contributed to an excessive investment boom. Nevertheless holdings of base money rose strongly relative to expenditure. The boom caused financial liberalisation. interest ceilings on bank loans ceased to be binding. Indeed, the commercial banks found themselves unable to lend available deposits even at substantially negative real interest rates.

Trade policy was liberalised during the boom. Private agents recognized this as a

actual outcomes with an explicit counterfactual, following the methodology and disaggregation used in the Kenya study, Bevan et al. (1990).

[3]This remarkable result can be checked against a calculation using National Accounts data which, postulating a counterfactual based on past behaviour, yields a similarly high private windfall savings rate.

temporary change since the government's policy rule was to vary trade restrictions in line with changes in reserves, keeping the exchange rate constant. This was reflected in a substantial increase in imports of consumer durables, a response which was privately, but not socially, profitable (Calvo, 1988).

While the windfall was not taxed directly, government revenue rose substantially so that around half of the windfall accrued to the government. Despite a history of fiscal conservatism, Treasury control broke down. First, the government failed to realise its intention of largely saving the windfall. Secondly, it was slow to reduce expenditure as the coffee price reverted to normal levels in 1979. As a result, there was a fiscal crisis in the early 1980s. During this period external debts were incurred and capital spending was savagely curtailed. Our estimate of the public windfall savings rate for the period of the boom itself (1976-79) is around 20%, far less than the savings rate of private agents[4]. Also, by 1979 the government financed investment through external borrowing: instead of dampening the investment boom through temporary foreign asset acquisition, the government accentuated it.

In summary, private agents, including peasants, were able (contrary to the assumption underlying the policy consensus) to recognize the boom as temporary and to respond by saving a substantial part of it. Constrained by foreign exchange controls to domestic assets, they translated their windfall savings into capital formation very rapidly This led to a construction boom (reflected in an increase of the relative price of non-tradable capital goods) and to an extremely low marginal return on investment. The public sector response led to a recurrent expenditure boom and a budget deficit. Public capital formation was rephased in a way which accentuated the construction boom, thereby reducing the increase in the capital stock. Prima facie, the control regime (in particular exchange control and the absence of attractive financial assets) and the fiscal response were responsible for derailing Kenya's best opportunity for growth.

New Evidence on Trade Shocks

We now consider the results of the sixteen country studies to see to what extent these conclusions can be generalized.

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[4]If we allow for the repercussions during the early 1980s it becomes negative.

Private saving. Since stabilising taxation was the policy norm there are few cases in our sample where private agents were the initial recipients of a windfall. Where this was the case - the coffee boom in Costa Rica, the groundnuts boom in Senegal - we find that, as in Kenya, they had a high savings rate. However, there are three cases where the private sector received a boom, but appears not to have saved much of it: about 33% in Colombia, 15 per cent in Cameroon and nothing in Ghana. In all three cases the windfall did not accrue directly to the private sector but was transferred to it. In Colombia after many years without political competition, contested elections were restored during the coffee boom and rural votes became important. The government monopsony in coffee trading was abolished and while official coffee prices stayed low, unofficial prices rose as private traders were allowed to compete to buy coffee from farmers. This price increase may well have been regarded by farmers as being mainly due to the political change and therefore longlasting[5]. In Ghana during the cocoa boom an export tax kept the nominal producer price constant. As a result the real price fell substantially and in the first instance producers experienced a negative shock while the boom accrued to the public sector. About three quarters of the windfall was subsequently transferred to the private sector, largely through increased public employment. Hence private agents received a windfall in a highly confusing form: while real income from cocoa fell, private agents benefited from transfers to public enterprises. In Cameroon the oil shock was also partly transferred to the private sector through the budget. Here the process was even more obscure because oil receipts were deliberately shrouded in secrecy. While this was effective in avoiding a budget deficit, it made it difficult for private agents to judge the sustainability of the higher level of government expenditure.

We conclude that there is no case for stabilising taxation in the case of positive shocks. While there is not yet sufficient evidence, private agents do appear to respond by saving a substantial part of an untaxed windfall. Where the control regime is such that a boom accrues initially to the government the private sector response to a subsequent transfer is likely to be appropriate only if the transfer is clearly linked to the trade shock and if the absence of ratchet effects is fully credible. Unfortunately, these conditions are unlikely to be satisfied.

Public sector saving. In Kenya the public sector savings rate was low, substantially

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[5]Similarly in Senegal the "True Prices Operation" which raised producer prices was introduced after a long period of confrontation between farmers and the government. Farmers may well have interpreted the passing on of world price increases as a political victory, reflecting a permanent improvement in their position quite unrelated to the boom.

below that of the private sector. However, this does not generalise. Many governments realised quite high savings rates (often in excess of 60%, in a few cases close to 100 percent) out of windfall income: Nigeria, Indonesia, Zambia, Cameroon, Botswana, Colombia, Niger, Côte d'Ivoire, Malawi The high savings rate realised by the Botswana government reflected the asymmetry which the government perceived in the cost of mistakes. Mistaking a temporary positive shock for permanent (or a permanent negative shock for temporary) was seen as much more costly than the reverse errors (Hill, 1991). The government therefore responded to a positive shock by saving as long as its nature remained unclear.

Even when high savings rates were realised, in almost all countries public expenditure increased substantially and this was often accompanied by a loss of control so that a fiscal crisis ensued in the post-boom period. Colombia is a notable exception. There the government responded to the coffee boom by reducing its own expenditure in an attempt to dampen inflation. In some countries revenue collection varied endogenously in response to trade shocks: in Côte d'Ivoire and in Senegal collection efforts slackened during booms so that part of the windfall was transferred inadvertently to the private sector. In Kenya and Malawi we find the opposite response: booms were transferred to the public sector partly through tax increases.

Use of foreign assets. Where private agents could accumulate foreign assets (e.g. in Egypt) they did so. But in many cases, particularly in Anglophone Africa, exchange control prevented private foreign asset accumulation. In addition, financial repression made domestic financial assets extremely unattractive (in Ghana real interest rates fell to minus 36 per cent) so that investment booms were reinforced. This was costly. For example, in Malawi private agents forewent a 16 per cent real rate of return as a result of not being able to hold foreign assets and repatriate them when the increase in capital goods prices had subsided.

The studies show an enormous variation in public sector use of foreign assets. Public sector windfall savings were temporarily parked abroad by the governments of Indonesia, Botswana, Colombia, Cameroon. In Cameroon the government succeeded in resisting the pressures for domestic expenditure to which most governments succumbed by keeping funds offshore, by shrouding the magnitude of the windfall in secrecy, and by keeping control over the funds with the President's Office rather than spending ministries. Similarly, Indonesia kept some of the oil money in secret accounts. Botswana used its savings from positive diamond shocks to build up enormous foreign reserves. Initially there was an attempt to disguise the windfall: it appeared only under obscure items at the bottom of the budget. Thereafter, however, there was an open campaign of education within the government. The dismal example of the Zambian copper boom was used to concentrate minds. Colombia, with a long history of temporary booms, is the case in which the attempt to save windfall income was institutionalised through the coffee fund. However the foreign asset strategy implemented in the first part of the boom (1976-78) was dependent not so much upon existing institutions as on the preferences of the president. After the 1978 election the strategy was abandoned as the new president embarked on a spending spree. The four cases therefore do not suggest an institutional arrangement which can readily be copied.

A second group of countries (Niger, Zambia, Costa Rica) failed to stretch the investment boom, either by not accumulating foreign assets at all or by already repatriating them during the boom. A third group (Nigeria, Côte d'Ivoire, Malawi, Mexico), far from accumulating foreign assets, borrowed during the boom, making use of improved creditworthiness Finally, in Senegal the government used windfall savings plus the proceeds from external borrowing to buy foreign-owned firms. This Senegalisation program amounted to the acquisition of illiquid foreign assets so that the smoothing objective could not be realised. In addition, the productivity of these firms deteriorated sharply when they became public enterprises.

Hence very few countries managed to use foreign assets effectively for stretching an investment boom.

Construction booms and returns to investment Since most windfalls were largely saved while few countries chose to hold savings abroad, commodity booms led in most cases to very pronounced investment booms[6]. This happened in Kenya, Costa Rica, Côte d'Ivoire, Cameroon, Zambia, Egypt[7]. Usually this led to higher prices and increased output of non-tradable capital goods, that is to a construction boom[8].

Invariably, the rate of return collapsed when investment was concertinaed. Nigeria

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[6]In most of the countries in the sample the investment boom was savings driven. With an open capital account the savings effect leads to foreign asset acquisition rather than domestic investment. The Mexican investment boom is therefore not explained by windfall savings.

[7]Malawi is an interesting exception: expansion of the construction sector was constrained by credit, financial controls favouring credit to agriculture.

[8]The exception is Botswana where even construction services are basically tradable so that investment could be increased without cost increases.

and Zambia provide examples of boom-financed expansion of an heavily protected import-substitute sector, much of it with low or negative value added at world prices. Poor returns are also reported for Malawi, Costa Rica, Mexico, Niger and Côte d'Ivoire. Often the boom financed investment projects which had previously been turned down as uneconomical (Mexico, Malawi). Conversely, whenever investment booms were stretched as in Colombia and in Botswana, there is evidence that rates of return held up. Clearly, investment stretching is not a sufficient condition for reasonable returns but it does appear to be necessary.

Endogenous policies. In Senegal trade restrictions were tightened during a boom in a deliberate attempt to offset the adverse Dutch Disease effects of a windfall on non-booming tradables. Obviously, this is a highly inefficient policy response. In most countries, however, trade policy was liberalised during booms or tightened during slumps, as in Kenya. This happened in Malawi, Colombia, Nigeria, Costa Rica and Egypt There is clear evidence of a Calvo-effect (in the form of an extraordinary rise in imports of consumer durables) for Malawi and Costa Rica. Both Indonesia and Botswana adopted exchange rate protection, depreciating the currency to protect non-booming tradables. Most countries relaxed monetary policies in boom periods. Colombia, Ghana and Niger, however, responded to booms with a ferocious tightening of monetary policy. In Colombia private investment did not rise because extremely high reserve requirements prevented banks from lending

Negative shocks. Since private agents are likely to encounter borrowing constraints, there is a much stronger case for the government to attempt to smooth temporary negative shocks by dissaving on behalf of the private sector than there is for a custodial role during positive shocks. However, a policy of dissaving can succeed only if it is fully credible. If private agents see the dissaving as a loss of control they will speculate against it in the anticipation that the crisis will eventually be resolved through devaluation or trade restrictions.

Indeed, with two exceptions, we find that governments dissaved under negative shocks and that this led to speculation which accelerated the collapse into crisis. In Costa Rica the government had successfully smoothed negative shocks by borrowing but this policy was no longer credible after the coffee boom because revenue earmarking and legal spending requirements had made fiscal retrenchment exceedingly difficult. In the first of the Venezuelan negative shocks, 1982, with convertibility under a fixed exchange rate, private agents reacted to the government's failure to adjust through capital flight (switching $6.5

billion of financial assets into foreign currency) and by stockpiling imports. During the second shock in 1986, a new multiple exchange rate regime severely limited the efficacy of these strategies. Instead, there was hoarding of domestic production and a move into non-traded capital. In Zambia where the fall of copper prices was treated as temporary (in line with World Bank forecasts) for more than a decade the private sector responded with illegal capital flight and, during a trade liberalisation window, massive inventory accumulation. In Côte d'Ivoire when after the beverages boom the government started accumulating debt, the private sector switched to foreign assets.

There were, however, two successful cases of government dissaving during negative shocks: Botswana (1981) and Bolivia (1986). In each case public dissaving was quite substantial (Botswana had a dissavings rate of 75 per cent) yet it did not produce speculation of policy reversal. Why were these stabilisations credible? First, both governments, although they dissaved, also quite savagely and swiftly reduced public expenditure. This made it less likely that the dissavings policy could be construed as loss of control over spending or simply as policy inertia. Secondly, dissaving was clearly sustainable for a considerable time, Botswana having enormous reserves and Bolivia having access to external capital through its prior policy reforms.

Conclusion

Policy responses to trade shocks vary widely, even by sign. There is evidence of policy changes in either direction in response to positive external shocks; this applies not only to trade policy but also to public expenditure, revenue collection and monetary policy.

Temporary positive shocks present an opportunity for permanently raising income. The evidence suggests that the opportunity is usually missed as a result of the regulation of private activity and the government's fiscal response to a windfall. We find that private agents tend to save a temporary windfall. However, when the boom does not accrue to them directly, the process by which it is transferred to them may disguise the temporary nature of the shock so that they fail to save. Governments usually handle windfalls badly. There are large differences between countries in public sector savings rates out of windfalls. While many governments managed quite high savings rates very few succeeded in smoothing investment expenditure and in avoiding a collapse of rates of return. Our tentative conclusion for positive shocks is that the policy consensus needs to be reversed. Rather than ensuring that booms accrue directly to the government or are transferred to it, mechanisms are needed which transfer public windfalls to the private sector in a way which does not obscure the link with the trade shock. The government can, for example, sell foreign exchange to the private sector at a floating rate. This would stabilize the budget and transfer public windfalls automatically to private agents through induced exchange rate changes. Since the policy rule is simple, the nature of trade shocks is not disguised by the transfer process.

In the case of negative shocks there is a case for government stabilisation However, a government dissaving policy will usually be considered as incredible and private sector responses will then make the policy infeasible. It is unlikely that the policy will be considered as credible unless government dissaving is accompanied by rapid fiscal retrenchment, as in Botswana and Bolivia.

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AGRICULTURE, RURAL SECTOR AND ENVIRONMENTAL SUSTAINABILITY IN AFRICA

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SECTION ONE: INTRODUCTION

Until recently, agriculture in western economic development theory was viewed largely as a passive and supportive sector of an economy. In the main, its role is to provide sufficient food at the cheapest possible cost and 'release' surplus labour to the industrial sector which is supposed to be the 'dynamic leading sector' in any overall strategy of economic development. Today, however, development economists have come to realize that far from playing a passive supporting role in the process of economic development, the agricultural sector, in particular and the rural economy in general need to be the dynamic and leading elements of any overall strategy, at least for the vast majority of contemporary Third World Countries (Todaro, 1989).

For sub-saharan African countries, agricultural production is not just important, it is basic to their survival if development is to take place or at least if the present level of civilization is to be maintained. This is because:

(1) The pace and intensity of industrialization as experienced elsewhere in the world leaves so much to be desired in these countries:

(2) Most of these countries lack mineral resources from which they can earn any substantial revenue to embark on developmental programmes. For the few countries with substantial mineral resources, inept socio-economic and political institutions and policies have stalled their capability of tackling the problem of poverty and food security especially in the rural areas where most of the people live.

(3) These countries have abundant resources (of land and labour) for the development of the agricultural sector. It is known for example that 16% of the total African land area is considered suitable for agriculture yet only 6% is actually cultivated (Myers, 1993).

The agricultural sector is dominated by small scale peasant farmers who until recent times produced for subsistence. These farmers have always been aware of the delicate nature of the rich tropical soils and have thus evolved several agricultural practices in their bid to optimally manage the soil resources sustainably, increase soil productivity and hence, returns for their efforts. The most widespread of the farming systems is shifting cultivation and pastoralism. However, the monetization of the traditional economy; increased population pressure and the inability of the farmer to improve on his technology has made shifting agriculture unsustainable with time.

This paper discusses the features of African agriculture with special emphasis on their impact on the environment.

The paper is divided into seven sections. In section I, the paper is introduced. Section II discusses the characteristics of the rural areas while Section III focusses on the trend of African agricultural production particularly since the 1960's. In Section IV, the paper examines the dimensions of the sub-saharan African rural and agricultural problems while Section V deals with the implications of the rural agricultural economy on the environment. Section VI discusses new approaches towards achieving agricultural and rural sustainability while in Section VII, the paper is concluded.

II. CHARACTERISTICS OF THE RURAL AREAS:

Over 2.7 billion Africans lived in rural areas in the last 1980's. By 1990, according to UNDP (1991) report, about 69% of sub-saharan African population live in the rural areas while the total for the world is 55%. It is estimated that almost 3.1 billion people will be living in the rural areas of Africa by the year 2000.

In Africa almost every country has rural dwellers in excess of 75% of their total population. In spite of the massive migration to the cities, the absolute population increase in rural areas of most Third World nations will continue to be greater than that of urban areas for a long time to come (Todaro 1989). Table 1 gives detailed information on Population Growth rates and fertility rates in sub-saharan Africa.

The wave of migration from the rural areas to urban centres have their origin in the fact that the rural areas have suffered economic stagnation since African nations became independent. The neglect of the rural areas have variously affected the sustainability of the rural areas. The UNDP (1991) report indicated that as at 1990, only 37% of rural dwellers in sub-saharan Africa had access to health services as against 72% of urban dwellers. While 74% of urban dwellers had access to portable water, only 26% of the rural dwellers enjoy that 'privilege'. Finally, while 60% of urban dwellers could lay claim to enjoying sanitation services, only 18% of the rural dwellers enjoy same. Rural dwellers are thus forced to depend on mother nature to provide these facilities and with increasing population pressure have had negative effect on the environment. The rural areas lack basic amenities. More often than not they are not supplied with electricity which makes the development of non-farm enterprises almost impossible. They are not linked with good access roads which also prevents their farm produce from reaching the urban market where they are in high demand and thus limiting rural income. In addition, inaccessibility does not facilitate the diffusion of ideas and innovations necessary to change and improve peasant production systems.

There are few hospitals to attend to their sick members which increases rural Mortality rate. There are few educational facilities beyond the elementary level (where they exist) which forces the young ones to migrate to urban centres to achieve their ambition to gain western education. They hardly return to the rural areas to live since there are few job opportunities (other than farming) nor social amenities to attract them. Those involved in migration are the young and virile coupled with other factors of land degradation etc., the rural areas are unable to perform efficiently the function for which it employs 70% of the entire labour force of sub-saharan Africa producing enough to meet the African food demands.

Rural livelihood in sub-saharan African nations are largely agricultural based. Over two billion people in the third world countries live on agriculture in the rural areas. Agricultural processes vary over space in the region depending on the ecological endowment. In forest regions, with long rainy season, tree and root crops are grown while in the savannah regions, grounds are cultivated and cattle rearing is also prevalent in the savannah regions.

However, African agriculture has two basic similarities:

(1) they are low resource based. Very little capital input are utilised. The farmer depends more on his labour and traditional implements of hoes, cutlasses and fire.

(2) they are all basically shifting agriculture. The sedentary farmers practice shifting cultivation while the cattle rearer is a migratory pastoralist.

The employment of simple tools in shifting agriculture have serious implications for the environment. The dependence on forest sources for energy needs have further compounded the problem of deforestation, land degradation, desertification all of which perpetuate rural poverty.

III. TRENDS IN AGRICULTURAL PRODUCTION:

Agriculture is the most important single enterprise in sub-saharan Africa. It provides most of the food consumed and earns foreign exchange for most countries. More importantly it employs most of the labour force in Africa. Table 2 shows that as at 1985, 74% of the total labour force in Africa were employed in agriculture. This figure is higher than anywhere else in the world as the table clearly shows. According to UNDP (1991) Report, by 1988, as much as 67% of sub-saharan African labour force were fully engaged in agriculture.

Table 2 further shows that agricultural output constitutes 32% of the total African Gross Domestic Product (GDP). Thus inspite of the fact that the agricultural sector accounts for the employment of over 70% of the labour force, it accounts for a much lower share of the GDP. The fact that African agricultural employment is twice as large in proportion to the total as is agricultural output simply reflects the relatively low levels of productivity to labour.

Table 3 shows the trend in per capita food production in the world in 1985. While the table shows marginal increases in food production or stagnation in some cases; in Africa, the situation was worse. Per capita food production declined sharply in the 1960's and became ever worse in the 1970's and 1960's. The per capita food consumption may differ (i.e. be lower) from per capita food production as a result of international trade. It is clear that the average African suffered a fall in his level of food consumption between 1960 and 1980.

Since food consumption constitutes by far the largest components in a typical African's standard of living, the sharp decline in both per capita food production and consumption meant that the region as a whole was becoming even more underdeveloped during the period 1960-1985.

From 1985 to date the food supply and consumption situation have continued to worsen further heightened declining standard of living in Africa. Africa has been facing severe food crisis since the early 1970's. Between 1973 and 1974, severe famine hit the sahelian belt of Africa. Between 1982 and 1984 and 1987 and 1988 (Todaro, 1989), food crisis became much more widespread with more than twenty-two nations threatened by famine some of the nations threatened (in addition to the sahelian nations) included Zambia, Tanzania, Malawi, Uganda, Botswana, Mozambique, Zimbabwe and Angola.

The severe food shortage in Africa have resulted from insufficient and inappropriate technology, cultivation of marginal and sensitive lands, severe deforestation, soil degradation, inappropriate macro-economic policies and the problem of high population growth rates (see table 1). Thus sub-saharan food production has been unable to meet the rate of population growth. Declining food production coupled with other economically induced problems (like inflation, decline in real income, etc.) have resulted in a sharp fall in per capita food consumption particularly since the 1980's. The continent has thus been forced to depend on food imports. Per capita food production is expected to continue to decline at an annual rate of 1.2% with the result that the population of Africa living below poverty line is expected to increase from 60 to 75% (UNDP, 1991).

SECTION TWO:
DIMENSIONS OF THE PROBLEM

4.1: NATURE OF AFRICAN AGRICULTURE:

For centuries, shifting cultivation (among crop farmers) and migratory pastoralism or transhumance (among cattle rearers) have been the common feature of land culture. Under the prevailing ecological conditions and factor endowments, the systems were appropriate for deriving a livelihood in a sustainable manner from the natural resource endowment of their environment (Cleaver and Schreiber, 1992).

Under shifting cultivation, Farmers open up a piece of land and cultivate it for a period of 2-3 years. As diminishing returns sets into the productivity of the land after the third cropping, the farmer 'moves' to another piece of land. After another three years, he moves again to another plot. The original plots are allowed to 'rest' under fallow for a period of between 15 - 25 years subject to the total farmland at the disposal of the farmer. During the fallow period, the soil nutrients are naturally recycled via the decomposition of litter and plants through a constantly self-reinforcing biochemical processes. In addition, the secondary regrowth prevents the soil from being excessively heated by the sun. It also shields the soil from heavy tropical rain that causes soil illuviation and erosion. Agricultural production then was high and in harmony with the sustainability of the biophysical environment.

In the savannah regions of the Sudan where cattle rearing is most important, pastoralists resorted to moving their animals over space in order to ensure sustainability. In other words, pastoralism was not merely done to search for pasture especially during the dry season. It was also to ensure that the carrying capacity of a particular place in the grassland is not exceeded to avoid irreparable damage to the soil through compaction by animal hoofs.

These forms of agricultural practice, common when the biosphere was at equilibrium with its utilization with respect to the human population is presently incompatible with the increase in population, increasing ecological hazards, wide-spread wars and insecurity on the African continent, monetization of the traditional economy and the increasing loss of rich agricultural lands to other uses like mining, urbanization, road construction, etc.

With total African population estimated at 500 million and with the population growth rate and fertility rates in sub-saharan Africa shown in Table 1 it is abundantly clear that shifting cultivation and migratory pastoralism (transhumance) could not have been carried on indefinitely. With increasing population, fallow lengths have been reduced from 20 years to between 3-5 years (Oluwasola 1992) and in fact in areas close to urban regions the fallow periods have ceased entirely. The short fallow lengths are not sufficient for the soil to regenerate itself naturally. With time productivity falls which further compounds the problem of the rural poverty. Short fallow lengths also implies that in the process of ecological succession climax vegetation of forest would not have formed before the land is put under use again. This leads to deforestation and loss of wildlife habitat. Soils are eroded and rivers are silted downstream thereby endangering species in aquatic habitat.

Similarly increasing human and cattle production has caused grass to be harvested beyond the natural productivity of the field. Thus the grass vegetation has given way in most parts of the sahel and the sudan for desert encroachment.

4.2: LAND TENURE SYSTEM:

The land tenure system in a rural agricultural community in Africa is the system of rights and duties of the people with regard to the use of land as land belongs to past, present and future generations. Land tenure system has a communal character (Levi and Haviden, 1982) and provided considerable security of tenure on land brought into the farming cycle through customary rules of community land ownership and allocation of use rights to members of the community (Cleaver and Schreiber, 1992).

Individual farmers, and the family or other units obtain the right to cultivate a piece of land from the head of the community (chief, village headman, lineage head, elders, etc.). Where land is abundant, this right lasts only as long as the piece of land is being cultivated. once the land is left to fallow, the right to the land is relinquished while a new land is requested from the head of the community. Where land is relatively scarce, the right to a piece of fallow land is not forfeited by the original user. Land may revert to the community if it is considered that it has been left uncultivated for too long. It is also important that the system ensures that every member of the community has the right to cultivate some land.

As land becomes scarcer with the increasing demands of population or of external market for crops, cultivation ceases being regularly transferred from plot to plot and remains on a single plot, while the fertility of the land is maintained by more laborious methods than simply allowing natural regeneration (Levi and Haviden, 1982). The tenurial arrangement is such that an individual cannot sell his farmland. It may also effectively hinder investment in permanent crops that may improve soil fertility as it will mean reducing the parcel of land available to a farmer for immediate cultivation. In fact reforesting a piece of land may be impossible where the harvest of forest resources like timber is communal responsibilities.

In urban areas where population pressure has caused land speculation problems the sale of such lands have not yielded any direct benefit to the agricultural sector as such lands are used for urban development.

4.3: FARM TECHNOLOGY:

Over 70% of African food production is made by rural small scale peasant farmers using simple tools of hoes and cutlasses (machetes) inspite of the presence of plantations dotting the African landmass here and there especially in east and south

Africa. In the Savannah lands, bullocks are also used which reduces the drudgery of having to till the land in a hot blazing day on a bent back.

The cheapest means of clearing the land is fire. Thus, the African farmer clears a piece of land and allows it to dry sufficiently and then sets it on fire. When the bush is well burnt, it reduces the incidence of weed on the farm, however, useful soil micro-organisms and organic compounds are burnt in the process. At the end of the burning, the land is open and subjected to the direct impact of the sun and rainfall. In due course, the soil is illuviated and the soil fertility is washed off via overland flows. Strong winds and water erosion degrades the land further while the farmer moves to a 'new' land as soon as he feels there is decrease in soil productivity to repeat the process of land degradation again.

Yet, the process of soil formation is slow. At best when sediments build up quickly, the formation of 30 cm depth of soil may take 50 years. More usually, when new soil is formed from parent rocks, one centimetre of soil may need from 100 to 1,000 years (Myers 1993). Unfortunately, reversing the process by human or natural disturbance is usually done very quickly. Soils and forests can be degraded in a fraction of the time they take to form. The farm implements available to the peasant farmer, the size of his fragmented farmland and the tenurial arrangement have caused soils to be overworked, forests to be prodigally felled, the grasslands to be over grazed while many gifts of nature are maltreated and lost.

Unfortunately, the farm tools available to the peasant farmer limits the size of his farm and hence his income. Thus, he has no sufficient capital to invest in soil reclamation or purchase even the smallest input of fertilizer. At best he increases the size of his farm to make up for possible loss in revenue that may result from diminishing productivity of the soil (Oluwasola 1992).

SECTION THREE

V. ENVIRONMENTAL IMPLICATIONS OF RURAL AGRICULTURAL ECONOMY:

The increasing population in sub-saharan Africa, the land use system of shifting cultivation and the inefficient production technology have all worked together to adversely affect the natural resource base and ecological environment of Africa. Such environmental problems include deforestation, desertification, soil degradation, water resource depletion and climate change all of which have combined to stagnate Africa's food production, stall her development and perpetuate poverty especially in the rural areas.

5.1: DEFORESTATION:

Forests are basic resources of several products and serve many functions including climate regulations and other essential environmental functions. In sub-saharan Africa, deforestation is a major problem responsible for the loss of the functions performed by the forests. Forests and woodlands are cleared for farming and logged for fuelwood and timber. FAO/UNEP in 1980 as reported by Lanly (1992) estimated that 3.7 million hectares of the total 679 million hectares of sub-saharan forest and woodland were being cleared annually during the processes of farming and logging. Cleaver and Schreiber (1992) suggest that close to 3.8 million hectares have been lost each year during the 1980's through conversion to farmland. This is shown in Table 4 which also shows that reforestation amounts to only 229,000 hectares per annum during the same period. The Central African region is not as badly affected as the West Africa portion or Eastern Africa as shown in Table 4.

As forest and woodlands are destroyed, women's travel distance for woodfuel in rural areas especially increases. Forest products are lost and most wildlife (including forest dwellers like the Pymies) are threatened.

5.2: LOSS OF BIODIVERSITY:

Deforestation has important deleterious impact on biodiversity and wildlife habitat. Table 5 shows that 64% of the original wildlife habitat in sub-saharan Africa has already been lost. Loss of biodiversity and wildlife results from several factors including population pressure, deforestation, conversion of wildlife to agricultural uses as well as other human uses; over harvesting poaching and foreign debt servicing. Foreign debt servicing has forced many African nations into agricultural and industrial practices which involves harvesting resources at an unsustainable rates, which results in the devastation of the natural ecosystem.

SOIL DEGRADATION AND SOIL EROSION:

Soil degradation in Africa results from factors like the character of the African soil, intense soil drying during the dry season, heavily erosive seasonal tropical rainfall, wind erosion, and low-resource farming with inadequate soil conservation measures.

Soil erosion is usually accompanied by other aspects of soil degradation including the deterioration of soil structure, reduced soil moisture retention, soil nutrient depletion and a depletion of soil flora and fauna. Higgins *et al* (1982) pointed out that if soil degradation goes on unchecked, there will be decline in the productivity of African lands at an average annual rate of 1% between 1975 and 2000.

Table 6 shows that 80% of sub-saharan Africa's productive drylands and rangelands amounting to 660 million hectares are affected by sustained deterioration. The worst deterioration occurs in the Sudan and sahel regions, making West Africa most vulnerable.

5.4: DESERTIFICATION:

According to Bass (1990), more than half of the worlds estimated 40 million normadic pastoralists live in Africa. Between 1963 and 1983, (FAO, 1983), the number of cattle heads increased by 74% in Sudano-Saharan Africa, by 65% in humid and sub-humid West Africa and by 61% in Southern Africa. During the same period as shown in Table 6, the extent and quality of rangeland declined. With increasing population, sedentary farmers moved into areas hitherto used as cattle grazing lands and thus curtailing the 'movement' of transhumant normads. This has forced normads to keep their cattle on marginal lands and thus causing serious degradation to land and vegetation. Coupled with repeated drought, desertification has tended to spread outwards from the areas with high animal concentration. Today, it is estimated that about 44% of the African landmass is affected by drought (Myers, 1993). Lands far away from true deserts are also being degraded to a desert-like condition through poor farming practices.

5.5: WATER RESOURCES DEPLETION AND DEGRADATION:

Farming activities have also negatively affected the water resources of sub-saharan Africa. Rivers, lakes, swamps and coastal waters suffer from sedimentation, silitation and agro-chemical run-off. These problems result from soil erosion, deforestation, poor farming methods etc. aforementioned. Unsound farming practices further compacts the soil reducing the rate of rain water infiltration and thus leading to decline in ground water resources. The erratic rainfall especially in the sahel region has further compounded the problem of the drinking water of people and livestock especially in the rural areas.

5.6: ENVIRONMENTAL DEGRADATION AND CLIMATE CHANGE:

Although factors leading to global climate change are complex and for Africa in particular, the causes are poorly understood, there is little doubt that environmental degradation has contributed to climate change.

Forests are known to create their own environment i.e. create a micro-climate significantly different from that of the climatic region in which they lie. Deforestation in most parts of the earth has removed the moderating effect of forest on temperature. This has thus resulted in greater heating of the land surface and increased evapotranspiration and disrupted the hydrological cycle. It has also led to the accumulation of CO_2 and other green house gases which in turn has increased earth surface heating. The result is the reduction in rainfall especially in the sahelian zone and at the same time depletion of soil water. All these have heightened unsustainable use of the African environment and worsened her food production and consumption problems.

5.7: ENVIRONMENTAL DEGRADATION AND AGRICULTURAL STAGNATION

The problems of environmental degradation resulting from human impact in their efforts to produce food and fibre for their needs have had negative impacts on the productivity of the sub-saharan soils. Soil erosion and degradation are insidious processes (Cleaver and Schreiber, 1992), not readily apparent to farmers until the effects are severe and irreversible with the means traditionally available. At the onset of the problem, they make up for possible production losses by increasing the size of their farms and since most of them are illiterates keeping no data on farm transactions (Oluwasola, 1992) they are limited with knowledge of farm performance in the last two or three agricultural seasons. Thus even if the farmers could have done anything to salvage the land, they are never done until it is too late.

The activities of farmers thus deplete the soil of nutrients, diminish its moisture retention capacity and reduce the depth of the rooting zone for annual crops. In the past thirty years, food production in Africa has been on the decrease. This is as a result of the impoverishment of the soil through the degradation of the soil through the degradation of the environment which has taken place over a long period of time. This has led to the stagnation of African agriculture. In fact in recent years, recurrent drought has even caused a retrogression in the agricultural production and consumption in sub-saharan Africa.

Not only is African agriculture unable to sustain the people but the careless use of the land will in the long run not sustain even the insufficient production level except urgent steps are taken to tackle the problem of rural poverty and agriculture on environmental sustainability.

SECTION FOUR

VI. NEW APPROACHES TOWARDS AGRICULTURAL AND RURAL SUSTAINABILITY.

The discussions above point to two major problems plaguing sub-saharan Africa. Firstly, food production has been decreasing and per capita food production and consumption has not just stagnated, in some cases, they have retrogressed. Secondly, it was also pointed out that past and current landuse systems have resulted in massive environmental degradation. Environmental degradation particularly those touching on soil productivity has further fuelled the problem of inadequate food production. In both situations, Africa faces severe problems of agricultural and environmental sustainability that requires urgent attention. This section suggests some pathways towards increasing agricultural productivity and achieving rural development that is environmentally sustainable.

The figures given earlier shows over 70% of sub-saharan African population live on subsistence agriculture. Thus attacking the poverty and livelihood of people in the rural areas is a sure way of impacting rural development, increasing food production and maintaining a sustainable environment. Thus the rural area must be made the focal point of development strategies.

1. Rural dwellers must be accessed relevant technologies of tilling or harvesting natural resources that are environmentally sound. This will involve a host of multifaceted strategies of funding agricultural research institutions to develop technologies that are 'indigenous' to the environment and which are capable of increasing farmers level of productivity as obtains in developed countries. The government will need to access such technologies to farmers at subsidized rates at least at the initial period.

Such technologies to be developed should be such that will increase productivity per unit land and per unit labour. This is important to ease the current pressure on land. The technology should be such that it will eliminate shifting agriculture. In this, the development of agroforestry farms with leguminous plants are highly recommended. However in accessing agroforestry to the people, adequate research should be carried out to make sure variations in local natural resource endowment are incorporated to make it relevant to the needs of the people.

Policies that will outlaw farming on marginal lands especially in the sudano-sahelan region that is aiding the advancement of the sahara should be put in place. This will involve designating the lands in each country to uses they are most suitable for. For example, marginal lands should be forested and not opened for cropping or grazing.

Meller (1986) observed that accelerated output growth through technological and institutional changes designed to raise the productivity of small farmers must be followed by price incentives and appropriate pricing policies capable of making the farmers obtain maximum benefit from any increase in productivity.

2. Rural farming communities should be massively educated about sustainable natural resource conservation. The use of fertilizers, cropping techniques, water management etc. are information farmers should be accessed. New ideas and methodologies can be advanced through extension agents or farmers cooperatives. While it is desirable for governments to govern less, the peculiarities of African Farmers call for the establishment of 'demonstration' farms at community levels to be funded by governments for an on-the-spot education of farmers.

3. The governments should deliberately pursue policies that will stimulate domestic demand for rural agricultural products in urban markets as well as at the international markets. This is to be done to commercialize traditional agriculture away from the present level of subsistence. The current predatory relationship between urban and rural areas must be changed. Urban centres should become

catalytic in rural development by paying 'appropriate' prices for rural products. In addition the urban centres must provide some of the needs of the rural folks cheaply to sustain them.

4. The governments of sub-saharan African countries must promote diversified non-agriculture rural development activities that directly and indirectly support and are supported by the rural farming communities. Some of the activities necessary to be promoted include rural non-farm employment. This initially should be aimed at processing products from the farms of the rural dwellers. Thus, any increase in farm productivity will not be wasted. Such non-farm employment will increase rural capitalization and in the long run will liberate surplus labour from the farms. The reduction of farmers will also reduce land pressure and thus reduce the rate of natural resource degradation. Other productive activities other than those converting local products could be extended to diversify the rural economy. This is important to give means livelihood to rural farm workers who usually have nothing to do during off-season period.

In addition to providing rural employment, deliberate investments should be made in the provision of social services like portable water, electricity, health and educational facilities as well as road networks to service rural areas. The current situation in which only the urban centres enjoy social and health facilities will not help eliminate rural poverty. The cities have continued to attract the virile males and thus leaving women, children and the aged in the countryside. This has further reduced agricultural productivity. The rural migrants who are ill equipped educationally end up as delinquents in urban areas unprepared to assimilate them. The rural areas must be made to have some 'life' capable of attracting some city dwellers. In that way, rural areas will become symbiotic in their relationship with the urban centres.

One important way of achieving rural social development is to develop satellite towns within the rural set up to provide most of the attractions in towns.

SECTION FIVE:

CONCLUSION

This paper looked at the existing sub-saharan agricultural and rural sector situation and concluded that African food production while unable to meet the demands of the people is also environmentally unsustainable. Many African nations have resorted to begging to feed their people. Although the enormity of the food problem varies, those that were surplus producer nations have now turned to net food importers.

Figures provided show that agriculture provide employment for about 70% of African people and these live mostly in the rural areas. Whereas macro-economic policies of the governments have over time been urban biased and thus leaving the rural areas in abject poverty. Although in the 1970's and 1980's, development thinking of sub-saharan African governments tilted slightly in favour of the rural areas, it was a far cry from what was desirable to positively impact the rural economy.

While reasons were advanced for the low productivity level of African agriculture, the paper also pointed out that environmental degradation has substantially fuelled decreasing agricultural productivity. Since over 70% of sub-saharan Africans live in the rural areas, it is the view in this paper that one way to alleviate African poverty and allied problems is to positively impact on the rural economy hence, the various suggestions made in the paper favours improving rural life and agricultural productivity.

The implementations of the suggestions require substantial capital investment by the various African governments. The present situation where over 50% (and in some cases 240%) of total export earnings of African countries are used in servicing foreign debt will not augur well for salvaging the African environment. Presently, the need to service these debts have forced many nations on the continent to pursue r icultural (and even industrial) programmes that are at variance with environmental sustainability. It has limited the size of revenue required for developmental activities and thus making investments in environmental protection a luxury only to be desired. The advanced nations and western credit institutions must save the African environment. This they can do by substantially reducing their debt service burden by converting them to grants. In addition new capital is needed to be injected into the agricultural and rural sectors if environmental degradation is to be checked.

A concerted effort at checking degradation in Africa will be a step in the right direction. After all, the world is an integrative whole and while the direct effect is on Africa, there is no escape of the consequences of complete degradation of African environment for other parts of mother earth.

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Table 1:
Population Growth Rates and Fertility Rates in Sub-Saharan Africa

Country	1965-80	1980-90	Projected 1990-2000	Total 1965	Fertility Rate 1990
Angola	2.8	2.5	3.0	6.4	6.5
Benin	2.7	3.2	2.9	6.8	6.3
Bostwana	3.5	3.4	2.5	6.9	4.7
Burkina Faso	2.1	2.6	2.9	6.4	6.5
Burundi	1.9	2.8	3.1	6.4	6.8
Cameroon	2.7	3.2	2.9	5.2	5.8
Cape Verde	1.6	2.4	2.8	-	-
Central African Republic	1.9	2.7	2.5	4.5	5.8
Chad	2.0	2.4	2.7	6.0	6.0
Comoros	2.2	3.5	-	-	-
Congo	2.8	3.5	3.3	5.7	6.6
Cote d'Ivoire	4.1	4.0	3.5	7.4	6.7
Djibouti	-	3.3	-	-	-
Equatorial Guinea	1.7	1.9	2.3	-	-
Ethiopia	2.7	2.9	3.4	5.8	7.5
Gabon	3.6	3.9	2.8	4.1	5.7
Gambia	3.0	3.3	3.1	-	-
Ghana	2.2	3.4	3.0	6.8	6.2
Guinea	1.5	2.4	2.8	5.9	6.5
Guinea-Bissau	2.9	1.9	-	-	-
Kenya	3.6	3.8	3.5	8.0	6.5
Lesotho	2.3	2.7	2.6	5.8	5.6
Liberia	3.0	3.2	2.6	-	-
Madagascar	2.5	2.8	2.8	6.6	6.3
Malawi	2.9	3.4	3.4	7.8	7.6
Mali	2.1	2.4	3.0	6.5	7.1
Mauritania	2.3	2.6	2.8	6.5	6.8
Mozambique	2.5	2.7	3.0	6.8	6.4
Mauritius	1.6	1.0	0.9	4.8	1.9
Niger	2.6	3.5	3.3	7.1	7.2
Nigeria	2.5	3.3	2.8	6.9	6.0
Rwanda	3.3	3.3	3.9	7.5	8.3
Sao Tome & Principe	2.1	2.7	-	-	-
Senegal	2.9	3.0	3.1	6.4	6.5
Sychelles	1.9	0.7	1.0	-	-
Sierra Leon	2.0	2.4	2.6	6.4	6.5
Somalia	2.7	3.0	3.1	6.7	6.8
Sudan	2.8	3.1	2.8	6.7	6.3

Swaziland	2.8	3.3	3.5	-	-
Tanzania	3.3	3.5	3.1	6.6	6.6
Togo	3.0	3.5	3.2	6.5	6.6
Uganda	2.9	3.2	3.3	7.0	7.3
Zaire	2.8	3.1	3.0	6.0	6.2
Zambia	3.0	3.9	3.1	6.6	6.7
Zimbabwe	3.1	3.7	2.4	8.0	4.9
Sub-Sahara Africa	2.7	3.1	3.0	6.6	6.5
India	2.3	2.2	2.0	6.2	4.0
China	2.1	1.4	1.7	6.4	2.5

Cleaver K. and G. Schreiber: The Population, Agriculture and Environment Nexus in Sub-Saharan Africa. Table 2 p. 149

Table 2:
Output and Employment in Third World Agriculture, 1985

Third World Regions	Percent of Labour Force in Agriculture	Output of Agriculture Forestry and Fishing as % of G.D.P.
South Asia	72	34
East Asia (Including China)	65	30
Latin America	33	18
Africa	74	32

Source: World Development Report, 1988 Annex 3 Table 31.

Table 3:
The Growth (and stagnation) of per capita food and agricultural Output in Third World Regions and Developed Countries, 1950–1985

	Growth in Per Capita Food Production (%)				Growth in Per Capita Agricultural Produc.			
Regions	1948/52-60	1960-70	1970-1980	1980-85	1948/62-60	1960-1970	1970-1980	1980-85
Latin America	0.4	0.6	0.9	0.3	0.2	0.0	0.7	0 4
Far East (excluding Japan)	0.8	0.3	0.7	1.2	0.7	0.3	0.6	1.1
Near East (excluding Israel)	0.7	0.0	0.7	0.2	0.8	0.0	0 4	0.1
Africa (excluding South Africa)	0.0	-0.7	-1.2	-0.4	0.3	-0.5	-1.4	-0.3
All Developing Countries	0.6	0.1	0.5	0.3	0.6	0 0	0.8	0 5
Developed Capitalist Countries	1.1	0.9	1.3	1.5	1.0	0.6	1.2	1.3

Source: Todaro M. P. (1989) Economic Development in The Third World. Longman, Table 10.2 page 294

Table 4:
Sub-Saharan Africas Forest Area and Deforestation

	Forest and woodland in 1980 (000 hectares)	DEFORESTATION (1980'S) % per year	'000 hectare per year	REFORESTATION Reforestation 1980 ('000/year)
Angola	53,600	0.2	94	4
Benin	3,867	1.7	67	0
Bostwana	32,560	0.1	20	-
Burkina Faso	4,735	1.7	80	3
Burundi	41	2.7	1	3
Cameroon	22,300	0.8	190	2
Cape Verde	-	-	-	0
Central African Republic	35,980	0.2	55	-
Chad	13,500	0.6	80	0
Comoros	16	3.1	1	0
Congo	-	0.1	22	0
Cote d'Ivoire	9,834	5.2	510	8
Djibouti	106	-	-	-
Equatorial Guinea	1,295	0.2	3	-
Ethiopia	27,150	0.3	88	13
Gabon	20,575	0.1	15	1
Gambia	215	2.4	5	0
Ghana	8,693	0.8	72	3
Guinea	10,650	0.8	86	0
Guinea-Bissau	2,105	2.7	57	0
Kenya	2,360	1.7	39	13
Lesotho	-	-	-	0
Liberia	2,040	263	46	3
Malawi	4,271	3.5	150	1
Madagascar	13,200	1.2	156	15
Mauritania	554	2.4	13	0
Mauritius	3	3.3	0	0
Mozambique	15,435	0.8	120.67	5
Niger	2,550	2.6	400.5	3
Nigeria	14,750	2.7	-	32

Rwanda	230	2.3	50	4
Sao Tome & Principe	-	-	-	-
Senegal	11,045	0.5	6	4
Sychelles	-	-	14	-
Sierra Leone	2,055	0.3	504	0
Somalia	9,050	0.1	0	2
Sudan	47,650	1.1	130.12	17
Swaziland	74	-	50	7
Tanzania	42,040	0.3	370.70	11
Togo	1,684	0.7	80	1
Uganda	6,015	0.8		2
Zaire	177,590	0.2		1
Zambia	29,510	0.2		3
Zimbabwe	19,820	0.4		6
Sub-Sahara Africa	678,900	0.6	3,764	229

Source: World Institute Draft data from African Indicators Project; Table 13 March 1991 and Cleaver K. and Schreiber G. (1992) The Population, Agriculture and Environment Nexus in Sub-Saharan Africa; Table 18, p. 165

Table 5:
Wildlife Habitat Loss in Sub-Sahara African Nations, 1986

Country	Original Wildlife Habitat/1000 Km^2	Amount Remaining 1000 Km^2	Loss (%)
Angola	1,246.7	760.9	39
Benin	115.8	46.3	60
Bostwana	585.4	257.6	56
Burkina Faso	273.8	54.8	80
Burundi	25.7	3.6	86
Cameroon	469.4	192.4	59
Central African Republic	623.0	274.1	56
Chad	720.8	173.0	76
Congo	342.0	174.4	49
Cote d'Ivoire	318.0	66.8	79
Djibouti	21.8	11.1	49
Equatorial Guinea	26.0	12.8	51
Ethiopia	1,101.8	10.3	70
Gabon	267.0	173.6	35
Gambia	11.3	1.2	89
Ghana	230.0	46.0	80
Guinea	245.9	73.8	70
Guinea-Bissau	36.1	8.0	78
Kenya	569.5	296.1	48
Lesotho	30.4	9.8	68
Liberia	111.4	14.4	87
Madagascar	595.2	148.9	75
Malawi	94.1	40.4	57
Mali	754.1	158.3	79
Mauritania	388.6	73.9	81
Mozambique	783.2	36.8	57
Niger	566.6	127.9	77
Nigeria	919.8	230.0	75
Rwanda	25.1	3.2	87
Senegal	196.2	35.3	82

Table 6:
Extent of Soil Degradation in Major Regions of the World, early 1980's

	Total Productive		Productive Dryland Types					
	Drylands		Range-lands		Rainfed Croplands		Irrigated Lands	
	Area /million hectares	Percent Degra-dation	Area /million hectares	Percent Degra-dation	Area /million hectares	Percent Degra-dation	Area /million hectares	Percent Degra-dation
Sudano-Sahara Africa	473	88	380	90	90	80	3	30
Southern Africa	304	80	250	80	52	80	2	30
Mediterranean Africa	101	83	80	85	20	75	1	40
Western Asia	142	82	116	85	18	85	8	40
Southern Asia	359	70	150	85	150	70	59	35
U.S S R. in Asia	298	55	250	60	40	30	8	25
China and Mongolia	315	60	300	70	5	60	10	30
Australia	491	23	450	22	39	30	2	19
Mediterranean Europe	76	39	30	30	40	32	6	25
South America & Mexico	293	71	250	62	31	77	12	33
North America	405	40	300	42	85	39	20	20
TOTAL	3,287	87	1,486	62	570	60	131	30

Source: UNEP and Cleaver and Schreiber (1992): The Population, Agriculture and Environment Nexus in Sub-Saharan Africa, Table 23 p. 170

THE AFRICAN ECONOMIC CRISIS AND THE GOVERNANCE QUESTION

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Introduction

In spite of the fact that majority of subSaharan African countries have embarked on Structural Adjustment Programmes in the 1980s, achievements even by the core adjusting countries have not been significant. At best they have been modest. For subSaharan Africa as a whole, the economic and social indicators suggest that the crisis of the 1980s show few signs of abating as we enter the decade of 1990s. Whereas the percentage of the absolute poor ($370 income per annum) in most regions of the world is declining, Africa's seem to be increasing and stood at about 50% in 1990 when the average for the developing world is 30%. The continuous decline in economic growth has been arrested but is nowhere near the expectations if Africa is to experience recovery.

The critical question to pose is what then has gone wrong with the promise and performance of economic reform in Africa? Or is economic growth going to remain unattainable for the majority of African countries - reform or no reform?. Africa faces the peculiar circumstance in which economic and political reform must proceed simultaneously. Does this pose any fundamental conflicts or can the two mutually reinforce one another? More importantly, the period under consideration coincides with a time when other developing countries especially in Asia have made impressive strides. Are there any lessons which can be learnt by African countries from the experience of these countries?

I. African Economic Performance In the 1980s and 1990s: Modest Gains and Serious Problems.

According to available statistics, Africa has made modest gains since 1980. Average Gross Domestic Product rose from 1.2% in 1981-85 to 2.6% in 1986-89 and even though it declined to 1.9% in 1990, it is estimated to rise again to almost 3% in 1991. This is far below the target expected in the World Bank's projection for Africa's economic recovery and is far below the growth for comparative countries in Asia (China, India, Indonesia and South Asia). As is evident from Table 1, agricultural and industrial sectors, the key productive sectors have experienced a similar trend - some improvement above the 1981-1985 figures, but modest, inconsistent and below the expectation for recovery articulated in the World Bank's strategic plan for Africa's economic recovery or the experience of comparable countries in South Asia. Export Growth improved considerably in 1991 after a long decline but fell again in 1991 due to Africa's declining terms of trade. Foreign investments also fell in the 1990s just as Debt Service Ratio increased to 30.8% but for countries like Uganda the debt service ratio was 63.2% in 1991. In the meantime, Africa's external indebtedness had risen to almost $300 billion. Life expectancy has improved marginally from 45% to 50% but remains the least among the world's regions. The percentage of those with access to safe water rose to 46% in 1990 from 35% in 1988 and less than 60% have access to health services.

Most assessments of Africa's development performance note the modest progress already recorded but warn that Africa is yet to break its developmental gridlock. According to Table 2, Africa is the only region of the world in which poverty is increasing and is expected to include one-half of the population by the year 2000 A.D. For other regions, there is a perceptible decline in poverty levels. Table 2 also shows other important contrasts between Africa and the rest of the world by 1990. According to the United Nations Development Programme <u>Human Development Report for 1991</u>:

> The outlook for Africa is bleak unless concerted international efforts set the continent on a more positive course. The potential is there. Africa has the people and natural resources to create a much more prosperous future. But it will require substantial human investment, as well as a major restructuring of economic policies (p.36).

II Lessons of the African Experience at Economic Restructuring

The critical questions that must be raised at this point are: First, are African countries applying the wrong dose of medicine to cure their ailments, that is, is it the content of economic policy that is in-appropriate or defective or is it a failure of implementation? Or can one argue as some have done that African economies defy restructuring and reform? This leads us to pose a second and related question - what lessons have been learnt from over one decade of Africa's efforts to raise production levels? Finally, can the lessons of other developing countries, especially in Asia, which seem to have transformed from developing to developed-country status be regarded as relevant to Africa at this point in time?

The postion I am taking in this paper is that the problem with Africa's economic reform may not be so much with the <u>content of the reform</u> programme as it is with the <u>strategy of articulating and implementing reform</u>. I wish to argue that the state has critical roles to play in the process of economic transformation. It can neither be by passed nor ignored. Were the transformation of the African state prove to be an impossible task, public sector organisations (and especially the civil service) must be revitalized and made effective, accountable, and able to initiate strategic initiatives which will make economic recovery not only attainable but sustainable.

Unfortunately, the state as well as its key instrument - the public bureacracy - have turned out to be particularly problematic in Africa. These two institutions have turned out to be not only highly centralized and unaccountable, they have been opaque, corrupt, self-serving and insensitive to the economic fortunes and misfortunes of their respective countries. The initial response African protagonists of economic reform to this problem has been to bypass the two institutions involve them minimally. Our experience seems to underscore the crucial importance of having at least one of these institutions play its key roles.

While it is true that African economies face severe problems within the international economy (declining terms of trade of commodity prices, increasing protectionism, fluntuating oil prices and the vagaries of the weather etc), without the critical political institutions which can stimulate private entrepreneurs to provide appropriate responses to these problems, the best efforts at economic reform is bound to be nullified. I shall indicate below the type of functions which only public agencies can provide and which they must provide efficiently and adequately if economic recovery and growth are to become realities.

But first what have been the major lessons of the African economic reform experience to-date? The World Bank has been in the forefront of efforts to reform African economies. To a large extent it has succeeded as over two-thirds (34) of the 52 odd countries on the continent have embarked on some form of the World Bank's version of economic restructuring. The Bank in a recent appraisal of its effort in this regard in Africa noted some significant achievements and important lessons. For the achievements, only 15 countries which it regarded as 'core-group adjusters' (Burundi, Gambia, Ghana, Guinea, Kenya, Lesotho, Madagascar, Malawi, Mauritania, Namibia, Nigeria, Tanzania, Uganda, Zambia and Zimbabwe) have recorded favourable movements in real producer prices, GDP growth rates, while inflation and deficits fell.

However, a number of lessons have also become evident - the more so as the majority of the African countries are outside this group of 'core-adjusters'. See Table 3

First, the liberalisation of African economies without a simultaneous liberalization of the world markets for Africa's traditional exports has been counterproductive. This is not to deny the need for economic reform and liberalisation but to underscore the point that export orientation is not the facile answer to economic recovery, as was once thought. Second, African government's capacity to fulfill their basic tasks is weak. Hence, even, additional resources allocated for social services have not translated into effective social services also because of the weak machinery for the delivery of social services and cost recovery. In addition, African governments' policy and implementation profile on privatization is also weak.

Thirdly, the World Bank has recently discovered that changing the structure of an economy is a long-term not a short-term process. Fourthly, it is essential that domestic actors (government and non-governmental) are fully involved in reform and actually 'own' the reforms in order to sustain such reform efforts. According to the Bank:

> No amount of externally imposed conditionalities, however, beings and beneficial will turn an economy around. The Bank is actively seeking to increase the participation of private sector, non-governmental, labour and other groups in its projects and programs. The Bank is also designing its projects and programs with more attention to the capacity of governments to implement them (p. 10).

One can sum up that African experience at economic reforms to-date has been an attempt of international financial institutions to displace the state as the stimulator of change (through policy analysis and advocacy), promoter of an appropriate macro-economic environment for private sector development and the provision of infrastructure, subsidies and safety nets for the poor. Even though one can appreciate why this was the most reasonable thing to do in the circumstances of the state-centred monopoly of the 1960s and 1990s and remarkable progress has been made, there is a limit to how much the World Bank can achieve - and this has been correctly identified.

What role is the State expected to play in Economic Change and Recovery? First, the state must provide an enabling environment for the private sector to thrive. It must not repress but encourage private sector initiatives. It must guarantee peace, sound system of adjudiction and administration of justice. As the experience of the Asian countries also show, the State must help to reduce uncertainty faced by private entrepreneurs by supporting innovations. Moreover, it must provide and maintain an essential and functional level of infratructures especially an efficient and reliable system of social and public infrastructures (health care, education, water, transportation facilities etc). Secondly, the state must create a regulatory regime that fosters domestic and international assistance to small scale businesses in the informal sector. Thirdly, it must not only maintain law and order but develop and supervise ethnical standards (fair competion, product quality etc) for public and private operations.

Finally, the state must avoid the mistakes of yesterday - the domination of the market by the public sector. It should encourage private sector organisations to provide 'private goods and services', it should persist in the task of economic reforms (privatization, commercialization etc) but also of increasing participation and efficiency in the public realm - what is referred today as the democratic transition.

The implication of all of these is that the state must play an active part in dismantling the governance structure it put in place over the last thirty years since political independence was attained by the majority of the African countries and learn to perform new functions. In the economic realm, it must learn to act strategically without threatening private businesses. In the political realm, it must stimulate and enhance the growth of a variety institutions within and outside the state such that each of these institutions - private sector, informal sector, the press, legislators, judiciary, local governments, non-governmental organisations - play their respective roles in nation-building. This is a complete reversal of the monocrotic approach to governance by most of the African states since independence.

The state must play these roles in Africa because of the fact that a lot of the economic and social problems confronting the continent arise from the belligerent positure of the state up-to-date. The leading economic and social scourges in the continent include: social disorder and unrest including civil wars, insurrection, consequent high defence expenditures (compared to GDP and socially-oriented expenditures), high population/urbanisation growth rates, high illiteracy levels, weak or non-existent social infrastrucutures and high debt and high debt servicing.

There is a sense in which each of these problems can be related to the defective system of governance.

First, the poor coverage of health and education facilities in most rural parts of Africa where the majority live for instance explains the poor coverage of family planning programmes, low female education and therefore the fact that Africa's population growth rate of (3.1%) has continued to increase when all other continents are declining. Even the developing world coverage is (2.3%) in the 1980s.

Secondly, Table 4 shows that very many African countries have been involved in some form of civil unrest or the other. As a result, productive activities have been suspended and in a few cases (such as Ethiopia, Mozambique, Angola etc) only external aid has prevented massive deaths from starvation such as has been the case in Somalia and Sudan. In most cases, such major disruption have been caused by the attempt by political leaders to hang on to power at all costs or to deny opportunities for self-governance to groups demanding some level of autonomy in their lives.

With the military still ruling several countries and the spate of social disorder, it is not surprising that a high proportion of available resources are spent on defence or the military. Even though Africa's military expenditures either as a proportion of GNP or of spending on social services is not the highest in the world the African military has been more adept at deploying violence against her own citizens than defending her citizens against external aggression. Some countries in Africa, according to a 1990 report are spending between 10-30% of their total expenditures on the military .

Finally, in view of declining production and the need to carry out what has turned out to be costly (in money and human social costs) economic reforms, Africa's debt has increased to almost $300 billion and today has the unfortunate distinctive of the continent with the highest debt as a proportion of its GNP. Average debt-service ratio for subsaharan Africa was 27% of exports in 1991 but for some countries such as Uganda, Madagascar, Burundi and Cote d'voire the figures were 63.2%, 34.3%, 38.2% respectively. More not less African countries are having high debt-service ratios since 1991. It can be imagined that if a country puts 63% and 20% of its total expenditures on debt servicing and defence, all that remains for <u>all</u> domestic activities is less than 20%.

III Relevance of Asian Experience

In contrast to the dismal performance of African countries, international attention has turned in recent years to Asian countries especially the 'four tigers' which are the Newly Industrialising countries, NICs (Hong Kong, Singapore, Taiwan and South Korea) which have successfully trailed the Japanese and attained remarkable economic miracles within the last couple of decades. Writers often point to such factors as 'reliance on the market', 'establishment of rule of law in the economic sphere ' and 'the existence of domestic and international competition'.

However, a closer study shows that even though these countries relied on market forces, the state was crucial in ensuring appropriate market forces were canalized and utilized to national advantage. As a result, the NIC success is a demonstration of the role which an effective and patrotic state can play using the instrumentalities of its highly nationalistic public services.

It is also important to note that while these countries had authoritarian political structures, they pursued very vigorous economic reform agenda which has in turn made political reform necessary.

A recent study had this to say on the subject:

> Government involvement in reducing the uncertainty facing businesses and in providing support for innovation has been important.. The role of governments in the rapid industrial growth of those countries, with the possible exception of Hong Kong, seems to have been much greater than that allowed for by neo-classical economics. In the NICs (and Japan) powerful government agencies charged with the responsibility for overseeing economic planning, trade and industrial development have forged close relationship with the private business sector.. Government and private business, instead of behaving like adversaries, act as if they were linked in a 'quasi-government' organisation. Government support in the context of an outward - looking strategy helps to encourage risk-taking and innovation by business, while the hierachical relationship allows coordinated and timely responses to unforseen contingencies.
>
> The close working relationship between government and business in the NICs and the high degree of professionalism in the ranks of the civil service are well known (James et.al 1988: p. 23).

Whichever of the indicators of economic performance one examines in these countries: industrialisation, trade, mobilization of domestic savings, the development of financial institutions, land reform or the transformation of agriculture - the role of government - nationalistic, relatively honest and professional - was considerable.

The object of these lessons for Africa is that even though the state may not be democratic, it is possible to ensure that its bureaucratic agencies are efficient, transparent, fair, objective and sensitive to the nation's economic fortunes and are therefore committed to raising national productivity.

That this combination is possible is actually the most important lesson of the Asian miracle. How can an organization like the public service be made professional, patriotic, strategic even though the political system remains undemocratic or only nominally democratic ? To quote the same source already cited earlier:

> Governmental efficiency in economic managment in each of the NICs, has been facilitated by a

> policy-making process in which economic policy can be set independently of political pressures from various interest groups. Top political-military leadership provides backing for the decisions of economic technocrats, thus underating the political strength of groups prone to oppose market-based economic policies (labour unions, industries, landlords). Policy makers have been able to sustain economic reforms so that long-term economic benefits can be reaped (p.239)

The important question, however, is why have Africa's top military and political leadership not being sufficiently interested in national greatness to cooperate in bringing about positive change? Why are they, whether military or civilian authorities more interested in illicit personnal monetary gains which are usually stored outside the country rather than in the benefits of their own country and country men?

In order to fully respond to this question we must examine the issues related to goverance modes in Africa.

IV Governance & Revitalisation of the African State and and its Institutions

From this point of view the recent interest in governance or good governance as an important component of economic transformation in Africa becomes crucial. Unfortunately, much of the popular concern on governance seems to focus on pluralism and multiparty elections. In reality the issues are deeper and are elaborate than these.

Goran Hyden and others more have identified four components of governance - Authority (effectiveness/adequacy of government decisions in addressing community problems and the extent of popular participation that goes into that process). Reciprocity (the quality of social interaction). Trust (limits of Association) and Accountability (the extent to which the citizens exercise influence over their governor). According to Goran Hyden, the more of these prerequisites of governance are present in any political community, 'the stronger the probability of effective governance; the less of them the stronger the possibility of regime collapse' (Hyden 1992:14). For Hyden and co, therefore, it is not the form of democracy or governance that matters but its substance. Hyden however, expects all of these elements or prerequisites to exist together or in the same direction. In reality, however, a political community may have more of one and less of others. What then represents the most effective combination or the most crucial of these elements of effective governance? Going by this conception, however, it would seem that Asian countries are more advanced than Africans in terms of governance indices.

The World Bank focuses on more some of the critical institutions which are essential for governance. These are. Public Sector Management Improvement: Strengthening Accountability at macro and micro - levels especially through improvements in financial accountability and effective fiscal, policy and program decentralization, improving the legal framework and increasing Information Flow and Transparency of Governments.

The crucial question is that social forces must enforce and promote these institutions. The essential elements of a program of reforming the state in Africa must therefore transcend the state and its institutions to the civil society. The major elements or reform will include the following:

1. Separation of State from Society and using one to provide some check on the other.

2. Dipersal of power: from central and local and from the Executive to legislature and judiciary. Making power accountable.

3. Administrative Reform - that raises competence levels, enforces meritocracy and links this to improvement of national productivity, strengthened field adminstration system and a realistic and motivating wage structure - that can enhance genuine professionalism in the civil service ranks.

4. Development of Africa's Informal Sector - through the provision of critical inputs: land, credit, training, technology and enhancement of competition in domestic and international markets.

5. Considerable investment in human resources - thus increasing not only the quantity but also the quality of available human resources at all levels (of the educational system (primary, secondary/vocational and tertiary levels).

It is these critical areas that Africa also needs the assistance of the World community. A trans Africa economy has tremendous potentials. And this is why investment in human resources is a key requirement for bringing about economic change. Such investments will produce not only the economic actors (innovators and entrepreneurs) to spearhead economic transformation but also the informed social activists who can enforce the independence of institutions within the state and the civil society that will improve governance structures.

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Table 1 Africa's Economic Performance 1965-1991

	1965-73	1974-80	1981-85	1986-89	1990	1991	Comparator Countries 1990	WB Targets 1990s
GDP Growth Average Annual % Change	4.7	3.2	1.2	2.6	1.9	2.7	5.7	4-5%
Gross Domestic Investment as a % of GDP	(1983) 19.7	(1980) 21.9	(1985) 13.1	(1989) 16.3	15.4	15.7	30.1	
Agricultural Growth	2.2	1.0	0.6	2.4	1.8	2.1	5.6	4%
Industrial Growth	11.7	4.7	-0.5	3.3	2.1	2.9	6.6	5%
Export Growth	6.8	4.8	3.8	1.2	7.3	33	8.8	
Debt-Service Ratio	(1993) 8.8	(1980) 10.9	(1985) 26.5	(1989) 22.6	(1990) 18.6	(1991) 27.0	20.4	
Gross Domestic Investment	19.7	21.9	13.1	16.3	15.4	16.0	30.1	25%
Foreign Direct Investment (US $ million)	822	55	1,008	2,303	570	669	3,971	
Life Expectancy at Birth	45.1	47.3	49.3	50.5	50.6	50.8	64	
Access to Safe Watch	-	-	-	(1988) 35	(1990) 46	-	-	

Population Growth Rate	2.7	2.8	3.1	3.1	3.1	3.0	1.8	

Source: The Global Coalition for Africa - 1992 Annual Report: African Social and Economic Trends: Note Comparator Countries: China, India, Indonesia, South Asia.

Table 2: Regional Human Development Comparisons (Latest Years)

	South Asia	East and South-East Asia	Latin American and the Caribbean	Arab States	Sub-Saharan Africa	Development	Industrial World
GNP per capital (US$)	390	530	1,830	1,820	470	710	12,510
Life Expectancy (Years)	58.4	68.1	67.4	62.1	51.8	62.8	74.5
Under-five mortality rate (per 1,000)	151	57	72	106	179	116	18
Maternal Mortality rate (per 100,000)	410	120	110	290	540	290	24

Adult literacy rate (% 15+)	42	72	82	53	45	60	
Scientists and technicians (per 1,000)		-					
Annual population growth rate (1960-90)	3.0		39.5	-	-	9.5	139.3
Annual urban population growth rate (1960-90)	2.3	2.0	2.4	2.7	2.8	2.3	0.8
Annual Urban Population growth rate (1960-90)	3.9	3.9	3.7	4.6	5.2	4.0	1.4
Military expenditure as % of spending on health and Education	164	-	29	166	70	109	38
Population below the poverty line (%)	42	11	3	15	72	32	2
Female-male gap in literacy (M = 100)	49	[illegible]	95	58	56	66	-
Rural-urban gap in access to safe water (U = 100)	61	76	63	49	35	62	-

Source: United Nations Development Programme, Human Development Indicators 1991, p

Table 3: Economic Performance In Sub Saharan Africa
(Annual Average % Change):
Impacts of Economic Reform

	1975-80	1981-85	1986-90	1991
GDP Growth Rate				
Countries with Social Unrest.	2.9	1.4	15	-7.0
Countries in the Central Franc Zone (CFA)	4.4	3.1	15	1.2
Small Economies	5.0	4.6	33	0.6
Core Group of Adjusters	1.9	1.5	3.9	2.9
Growth in Agriculture				
Countries with Social Unrest	4.2	0.8	2.0	
Countries in Central Franc Zone (CFA)	2.7	2.5	3.0	
Small Economies	-	0.9	2.5	
Core Group of Adjusters	0.06	1.1	3.2	

Growth in Exports				
Countries with Social Unrest	0.5	-0.2	0.1	
Countries in the Central Frank Zone (CFZ)	7.2	1.5	2.3	
Small Economies	-	4.7	5.2	
Core Group of Adjusters	2.0	-1.6	3.4	

Sources: E.V.K. Jayeox, Africa: From Stagnation to Recovery Washington D.C. World Bank, 1993, p.6

Table 4 State of Africa's State of Political Order (1993)

Stable	Transitional	Fragile	Instability/Insurgency
Cape Verde	Uganda	Swaziland	Uganda
Mauritius	Tanzania	Chad	Ethiopia
Gambia	Ethiopia	Zambia	Malawi
Botswana	Malawi	Namibia	Angola
Zimbabwe	Mozambique	Kenya	Cameroon
	Nigeria	Ghana	Somalia
	Seychelles	Senegal	Sudan
	Niger	Niger	Zaire
	Rwanda	Benin	Togo
	Morocco	Guinea	Rwanda
		Burkina Faso	Algeria
		Egypt	Liberia

Source: Field Work , Enquiries from Country Delegates *Africa Year Book* 1993 (London) R

Note: It is possible for one country to be in more than one class
Stable - Democratic Institutions fully in place and respected
Unstable - civil war, state of emergency, one party states, shirmishes etc.
Transitional- Talks or activities towards democratic future
Fragile - Democratic institutions recently installed; severe economic/political problems endanger democratic transition

ICEG/CIRES Seminar on Effective Implemenation Of Policies for Growth and Development in Africa
April 20 - 24, 1993
Abidjan - Cote d'Ivoire

The African Capacity Building Foundation (ACBF) and Capacity Development's Challenges

Presented by: Pierre-Claver Damiba
Executive Secretary

May 1993

Ladies and Gentlemen,

I am grateful to President Ardito-Barletta for inviting me to attend this Seminar bringing Asian and Latin American Experience to Africa. I would like to congratulate him; it is a great idea, a timely and useful initiative. ACBF looks forward to developing a joint programme with ICEG. But the secret of the success of this seminar is the twinning arrangement with CIRES, the leading Centre for Policy Analysis in francophone Africa, under the competent leadership of Professor Joseph Yao.

I. Is capacity building in Africa demand or supply driven?

The demand for capacity building in Africa, in my view, is not given "a priori."

For instance some Governments have indeed lost faith in policy analysis, because they see it as excessively theoretical, ideologically motivated or merely, because the top African decision makers are "economically illiterate." Some other Governments perceive researchers in social science as "anti-government," and as intellectuals fuelling the opposition views with "scientific" analyses. They then decide to ignore resulting advices and proposed policy alternatives. In addition they may also feel that these exercises don't yield immediate results for the political and social consumption of their constituencies. The peasant in his farm in the country side, or the worker in a factory does not "eat" policy analysis!

In addition, many of the researchers and policy analysts lack communication skills. This has resulted in a major lack of understanding between them and the decision makers. Therefore the analysts find themselves in a "secluded esoteric world," with no limited impact on actual economic life. There is a certain urgency to properly address the issue regarding the links between "actual economic policy and research." The transition from research to policy as well as the translation of research into policy are not easy for three reasons:

(i) firstly, the language problem: highly technical papers prepared by researchers in all their mathematical glory are unlikely to be understood by those in policy making.

(ii) secondly, there is also the tendency of researchers to be comprehensive in their writings, leading to long papers that are unlikely to be read or understood by those in policy making.

(iii) thirdly, the problems faced by policy makers are highly specific and time bound. The policy maker is interested only in answers to particular questions; the general applicability or methodological novelty of answers is of no interest to him.

In that respect, I am glad to notice how ICEG through its publications addresses these issues, for example in the form of summary of books that are largely disseminated.

Even if the demand for policy research and analysis is not a given there is however, a high, actual or latent demand for capacity building in Africa. For example:

- Empirical observations show that there is no critical mass of African policy analysts and development managers in Africa. The brain-drain figures measure "negatively" the needs for Capacity Building in Africa.

    1. Overseas African talent amounts to 70.000 African skills in Europe.

    2. Technical assistance in economic policy making and development management provides a kind of "prima facie" evidence of local demand i.e. 100.000 expatriates in Sub-Saharan Africa. Local demand which increased by 50% during 1984 - 87, costing 4 billion US$ per year i.e. 7$ per capita. In that respect, I would like to refer you to the recently published book entitled "Rethinking Technical Cooperation (UNDP)," of which I was a contributor.

- Furthermore the African Economic Research Consortium (AERC) September 1989 report concluded that "the effective demand for professional economists ... exceeds the number currently supplied from local research and Overseas sources."

- As more African countries intensify major policy reform programs, the demand for well trained policy analysts and managers is growing. In that context the only maintenance, "re-tooling" of existing talents in Africa is by itself a major challenge that provides a high latent demand for capacity building activities.

The African crisis, I am afraid, could be summarized as a "Capacity Crisis;" the inability to respond quickly and decisively to a rapidly changing global economic environment and the same inability to adjust to these economic realities has been a point in case during the 80s. Africa by and large failed to cope with the economic shocks such as changing oil prices, the ups and downs in commodity prices, the emerging competitors, the over burdening debt, the technological pace and the shrinking of Africa's market shares.

There is also the pervasive lack of the basic elements for successful institutions: i.e. educated and well trained human resources, sound management systems, favourable policy environment, incentive packages otherwise "if you pay peanuts you get monkeys!"

Furthermore often in Africa, political regimes tend to be secretive, mistrustful and intolerant with dissenting views. This leads local analysts to confine to non controversial subjects. Some political regimes either do not have countervailing powers or they just tolerate window dressing. Therefore there is no debate, on professional ground, enlarging alternative policy options. In such context, existing individual and institutional capacities are not well utilised, if at all.

Crisis in higher education, measures also the capacity crisis, owing to declining budgets allocated to Universities, rapidly expanding student body; from 1200 graduates in 1960 to 100.000 in 1990, and inadequacy of curriculum and equipment. This crisis has led henceforth to a crisis of quality resulting in too many poorly trained graduates now entering the labour market.

Finally, the lack of consistent and coherent strategy from donors regarding capacity building has also contributed to the crisis. For example the practice of aid tied to the provision of foreign technical assistance and consultants, the lack of coordination, the supply driven assistance, the ineffective counterpart system, the inadequacy of aid to local institutional/cultural environment...

II. Brief on ACBF

To what extent is the African Capacity Building Foundation (ACBF) an adequate response to the capacity development needs in Africa?

ACBF's objectives are three fold namely:

(i) to build and strengthen indigenous capacities, both human and institutional, in economic policy analysis and development management.

(ii) to ensure effective utilisation of available individual talents and institutions.

(iii) to contribute to reverse brain-drain into brain-gain and develop networking of institutions as well as develop highly trained professionals in government, universities and private sector.

These objectives should be achieved through specific qualitative and quantitative goals that can be summarized as follows:

(i) firstly to ensure that Africa will have its own nucleus of first rate professional policy analysts and managers.

(ii) secondly to ensure that Africa will have its own institutional base for training, necessary to sustain and support growth and development.

(iii) thirdly to help Africa to be more firmly in control of its economic destiny. These objectives are translated into quantitative goals:

- for 1992 - 1995 : training of 1510 specialists in policy analysis
- by the year 2000 : training of 5710 specialists in policy analysis

ACBF is endowed with a budget of 100 million US dollars, for the pilot phase 1992-1995 which is provided by bilateral donors, some African countries and three multilateral agencies namely AfDB, UNDP and the World Bank.

ACBF implements the action program through three primary mechanisms:

- Direct Funding: this is achieved primarily through grants; the ACBF Fund enables the Foundation to provide continuing support for capacity building in policy analysis and development management.

- Co-financing; in that respect donors will be able to link their current capacity building resources with those from ACBF, hence maximizing support for a specific capacity building program or institution.

- Networking and information sharing; through this mechanism, associated programs will establish a networking and information sharing service so that donors and African governments can be informed of capacity building actions.

In creating ACBF, its founders were aiming to fill a gap in the overall field of capacity building in Africa. Indeed ACBF has comparative advantages that should bring about its effectiveness and timeliness as an international/inter-african body. These advantages can be summarized as follows:

(i) ACBF is a private international foundation open to innovative ideas and proposals, with a very limited bureaucracy.

(ii) ACBF, within its resource limitation, supports the African priority in capacity building and in working with Universities, Centres of research, governments, private sector, but also through twinning arrangements with similar organisations in developed countries.

(iii) ACBF's ambition is to couple quality and excellence as an ethics for itself and in working with its partners.

(iv) ACBF provides grant financing as well as co-financing through mobilization of complementary resources; in so doing ACBF acts also as a catalyst for resource mobilization.

Effective policy making and development management can only be achieved through means such as professional skills, national commitment to use these skills, establishment of conditions conducive to professional work and institutional arrangements for bringing independent analysts to bear on key decisions. This program is being tried out and implemented through ACBF's various initiatives and supported projects.

Two examples of projects funded by ACBF can illustrate how the Foundation is responding to specific demand:

(i) **In Senegal: Establishment of a Policy Analysis Unit**

The main objectives and activities of the projects are:

- To conduct studies and analysis on critical economic and financial policy issues relevant to the concerns of the Government.

- To contribute to the foundation of economic policy measures and/or assess new policy measures and proceed with impact assessments.

- To organize training of selected civil servants who will undertake research assignments as research fellows.

- To organize seminars for the dissemination of its research work and to acquaint staff from technical departments with more recent analytical tools and methodological issues relevant to their sectoral concerns.

This project is developed within the Ministry of Finance as a center of excellence directly linked to the policy making process of the Government. The risk of this project is that its team could be under direct pressure from the Cabinet to handle the day to day routine work.

(ii) **In Nigeria: Establishment of a Development Policy Center**

The objectives and main functions of the Center are three fold:

- Economic intelligence function: (i) analysis of the most current data on a continuous basis and public economic information; (ii) carry out impact assessment studies; (iii) research focussing on topics related to policy improvement/alternatives.

- Capacity building role: (i) training and tutelage to help build capacities of journalists, editors as well as of small economics and statistics departments of private companies, (ii) organization of study tours; (iii) organization and streamlining of linkages with smaller Policy Analysis Units.

- Information management through (i) a data bank on development policy issues; (ii) up-to-date library; (iii) various publications and regular workshops for exchange of experiences and dissemination of information.

This project is private and autonomous and commercially managed while remaining a non profit organisation.

ACBF Board has already approved 16 projects; they can be classified into three groups.

- 10 projects whose primary aim is to create national policy analysis or research institutions, although all intend to offer training through placements, courses and fellowships abroad;

- 3 projects whose primary aim is to reinforce the policy analysis and development management capabilities of existing national training institutions;

- regional projects: 2 training projects involve expanding and improving masters degree programs in economics; and a single project to establish a policy unit in the OAU Secretariat to assist in implementing the Treaty creating the African Economic Community.

Some of the projects will utilize local consultants. All 16 projects, then, collectively cover in some measure all six areas of the operational priorities. National projects are located in 13 countries: Benin, Botswana, Burundi, Côte d'Ivoire, Ghana, Guinea, Nigeria (2), Senegal, South Africa, Tanzania, Uganda and Zimbabwe. Two regional projects are based in Kenya and Ethiopia. The two regional masters programs will involve two universities in Francophone countries (Côte d'Ivoire and Cameroon) and at least 6 universities in Anglophone countries.

The total ACBF commitment for the 16 projects is just more than $37 million. This compares with a total project cost of about $95 million, for an average ACBF contribution of 40 percent. Not too much store should be put in this average however, as the projects are not all prepared on the same basis, with some failing to include all local costs.

The bulk of the ACBF commitment to date is for policy analysis institutions (54 percent - $20 million), with the balance shared between national training institution projects (13 percent - $5 million) and regional projects (33 percent - $12.5 million). The largest commitments are related to the regional training projects ($5 million to the AERC project and $4.5 million to the ACBF-EDI-ABD project). The largest national project commitment is $3.5 million for the Botswana Institute for Economic Policy Analysis. The smallest allocation is an initial commitment of $150,000 to the African Institute for Policy Analysis and Economic Integration (South Africa), but an additional commitment is expected once that project proves itself. Excluding the South African project, the average commitment for national projects is about $2 million.

III. Lessons Learnt

Based on two years of activities ACBF has already learnt some lessons that can be shared. I would like to highlight the following:

(i) Public or Private Policy Units?

In the ACBF Strategy and Indicative Work Program that guides the Foundation work primacy is clearly given to economic policy units to be located within government structures, such as the Office of the President, Ministries of Finance and Planning and Central Banks. The projects generally give weight to the independence of the proposed institution, giving descriptions such a "think tank," and "autonomous research institution." They have thus been classified as "national policy analysis or research institutions," rather than as "policy units" as such. So far, just one project, in Senegal, is located within Government itself.

The fact that the institutions are not located within government does not necessarily imply that they will be less effective than they might have been in feeding into the policy-making process. Indeed, the argument for retaining a degree of independence and autonomy is compelling, as it would not be desirable for the work of the institutions to be narrowed to meeting the everyday needs that politicians could impose upon them. On the other hand, by not being located within policy making structures, there is the danger that the work of the institutions may be ignored, and the institutions may themselves come to be marginalised, particularly if they fall foul of political leaders. This risk indeed is common to all these projects, but is less so in cases where government support for the projects appears to be very strong, and greater in cases where the projects have been privately sponsored.

(ii) **Opportunity - Fundamental to Capacity Building**

It is only through being given the opportunity and the challenge to perform that researchers in policy units and teachers and researchers in African universities will develop their skills, acquire experience and confidence and find themselves in the sort of stimulating environment that will keep them in post.

Similar comments apply to the development of local consultants: the Foundation can go a long way to fulfilling its mandate on developing local consulting capacity simply by ensuring that local consultants in all fields are given the opportunity to compete for work on all ACBF supported projects and secretariat consulting requirements.

(iii) **New Institutions vs Consolidating Existing Ones**

In a new institution trying to make its mark there is always the desire to innovate and to support new entities rather than to reinforce old ones. A new institution does imply a lack of inherited problems and thus the opportunity to move ahead rapidly. By the same token, however, a new institution may have start-up difficulties while systems are established, and almost inevitably capital and recurrent overhead costs will be higher.

Unlike the policy analysis area, the national training projects all involve strengthening existing training institutions. These projects may lack innovation, but they appear to be soundly based and generally well thought through. With narrower objectives than the policy analysis initiatives, and greater prior experience of similar projects, national training could well form the backbone of the Foundation's activities.

(iv) **Effectiveness and Sustainability**

The lack of effectiveness and sustainability of previous projects in the area of capacity building in Africa is one of the main underlying reasons for the formation of ACBF. A central problem in many countries is the abysmal remuneration of those in government or public institutions (such as universities). Without the structure of the public sector changing, so that absolute numbers decline sharply and those remaining are paid competitive salaries, those trained to be effective policy analysts within government are not likely to stay, and those remaining may not even be able to appreciate and use the work of autonomous policy analysis institutions, established outside of government structures precisely to circumvent the problem of inadequate conditions of service.

Such fundamental issues should be addressed directly otherwise, there can be no assurance of effectiveness and sustainability in capacity building projects. How can the chances of sustainability of projects be improved? Firstly, a project should be attuned to the needs and the capabilities of the country concerned and should not be over ambitious in relation to these needs and capabilities. By trying to keep projects small, they are more likely to be cost-effective, well managed, and to lead to a sense of ownership by the nationals involved. Secondly, while incentive packages for staff may have to be set above general national salary levels to attract the requisite calibre staff, they should not be set at international levels as these can only be achieved with on-going donor financing. Living and working effectively in one's own country has to be part of the incentive package.

A slightly different point of view is that sustainability should not be seen only as a function of the likelihood or otherwise of a project continuing after external finance runs out. The project has rather to be seen in context particularly in the case of projects creating new institutions, what is the effect on existing ones? If these are undermined, particularly if staff transfers to the new institution, success may be achieved in the new project at the expense of undermining the sustainability of older initiatives. On the other hand, if the old institutions have "ossified," and creating a new one would attract back experienced nationals from abroad, there may be a net gain from a national view point.

Most of the regional countries have embarked on economic structural reform and democratization programs. I see this enabling environment as a tremendous opportunity for promoting ACBF's activities in capacity building and thereby assisting African governments to improve their economic performance in the medium to long term.

The Foundation believes that strong and effective African government policy analysis units are essential in achieving long term sustained economic growth. The underlying reason for this belief is that once national economies are stabilised through sound economic policies, then a conducive environment would be created to facilitate further and wider development, inducing private investment in particular.

Pierre-Claver Damiba
Executive Secretary

ICEG Academic Advisory Board