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# INTERNATIONAL MONETARY AND FINANCIAL ISSUES FOR THE 1990s

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# INTERNATIONAL MONETARY AND FINANCIAL ISSUES FOR THE 1990s

## Research papers for the Group of Twenty-Four

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## Note

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# Contents

Page

*Abbreviations* ... *vii*

*About the authors* ... *viii*

*Introduction* ... *ix*

**THE NEGATIVE NET TRANSFERS OF THE WORLD BANK**

Göran Ohlin ... 1

*Abstract* ... 1
Background ... 1
I. The logic of the net transfer ... 2
II. Net transfers in a broader perspective ... 3
III. The stagnation in IBRD lending ... 4
IV. Individual borrowers ... 7
V. External factors in the slowdown ... 7
VI. IBRD lending practices ... 9
VII. Switches to other sources of finance ... 10
VIII. Prospects ... 10
IX. Projected IBRD net transfers ... 11
Conclusions ... 12
*Notes* ... 12
*References* ... 12
*Annex* ... 13

Page

**A CRITICAL REVIEW OF THE WORLD BANK'S APPROACH TO SOCIAL-SECTOR LENDING AND POVERTY ALLEVIATION**

Louis Emmerij ... 15

*Abstract* ... 15
Introduction ... 16
I. The renewed interest in questions of social policy and poverty reduction ... 16
A. The World Development Report 1980 ... 18
B. The World Development Report 1990 ... 19
II. Progress made over the last three years ... 22
A. The Poverty Reduction Handbook ... 23
B. Implementing the strategy ... 23
C. The World Bank Annual Report 1992 ... 26
III. A critical review ... 29
IV. An integrated approach towards socio-economic reform ... 30
V. Concluding remarks ... 32
*Notes* ... 32
*References* ... 32

**STRUCTURAL ADJUSTMENT POLICIES AND ECONOMIC PERFORMANCE OF AFRICAN COUNTRIES**

Nguyuru H.I. Lipumba ... 35

*Abstract* ... 35
Introduction ... 35
I. A review of "Economic Adjustment in Low-Income Countries" ... 37
A. Financial and structural policies of SAF/ESAF arrangements ... 38
B. Impact of policies on economic performance ... 40
C. Shortcomings of the IMF paper ... 40
II. A review of "Adjustment in Africa: Reforms, Results and the Road Ahead" ... 45
A. The reforms and results ... 45
B. The road ahead ... 48
C. The strengths of the World Bank report ... 50
D. Shortcomings of the World Bank report ... 51
III. Comparison of the two studies ... 55
IV. The design and sequencing of structural adjustment programmes ... 56
A. Appropriate sequencing of reforms ... 57
B. Inappropriate sequencing of structural adjustment reforms ... 60
C. Creating a sense of ownership ... 60
D. World Bank/IMF coordination ... 61
Conclusions ... 62
*Notes* ... 63
*References* ... 63

Page

**THE EAST ASIAN MIRACLE: WHY THE CONTROVERSY CONTINUES**

Robert Wade ... 65

*Abstract* ... 65
I. Introduction ... 65
II. The industrial structure argument ... 67
III. The total factor productivity argument ... 68
IV. The Republic of Korea's heavy and chemical industries drive ... 70
V. The South-East Asia argument ... 71
VI. World Bank economics versus East Asian economics ... 73
VII. The World Bank's stance on selective industrial policies: a modest conclusion ... 76
*Notes* ... 78
*References* ... 78

**THE FUNCTIONING OF INTERNATIONAL MARKETS FOR PRIMARY COMMODITIES: KEY POLICY ISSUES FOR DEVELOPING COUNTRIES**

Alfred Maizels ... 81

*Abstract* ... 81
I. Background: the continuing commodity crisis ... 82
  A. Overall commodity price trends ... 82
  B. Regional export trends ... 84
  C. Terms of trade losses ... 84
  D. Short-term commodity market instability ... 88
II. International commodity policy ... 90
  A. International commodity agreements ... 90
  B. Policy options for the future ... 91
III. Raising depressed levels of prices by supply management ... 92
IV. Reducing the adverse effects of excessive commodity market instability ... 95
  A. Buffer stocks and/or export quotas ... 95
  B. Towards more effective commodity agreements? ... 97
  C. IMF compensatory finance ... 97
  D. Other compensatory financing schemes ... 99
  E. Risk management ... 100
V. Longer-term commodity issues ... 102
  A. Diversification ... 102
  B. Protecting the natural environment ... 104
  C. Reducing barriers to commodity trade ... 105
  D. Improving the competitive position of natural raw materials ... 107
VI. Conclusions ... 109
  A. Short-term policies ... 109
  B. Long-term policies ... 110
  C. The trend towards market-oriented approaches to commodity policy ... 111
*Notes* ... 112
*References* ... 113

*Page*

**EFFECTIVE USE OF FINANCIAL MARKETS FOR RISK MANAGEMENT BY DEVELOPING COUNTRIES: A POLICY OVERVIEW**

Donald R. Lessard ........ 115

*Abstract* ........ 115
Introduction ........ 116
I. What is risk management? ........ 117
II. Sources and incidence of risk exposures ........ 120
III. Comparative advantage in risk bearing ........ 122
IV. Mechanisms for risk management ........ 125
V. National risk-management policy and the role of IFIs ........ 127
*Notes* ........ 130
*References* ........ 131

# Abbreviations

| | |
|---|---|
| ACP | African, Caribbean and Pacific States signatories of the Lomé Convention |
| CCFF | Compensatory and Contingency Financing Facility |
| CFA | Communauté Financière Africaine |
| EMS | European Monetary System |
| ESAF | Enhanced Structural Adjustment Facility (IMF) |
| FY | fiscal year |
| G-7 | Group of Seven |
| GATT | General Agreement on Tariffs and Trade |
| GDP | gross domestic product |
| GSP | Generalized System of Preferences |
| HCI | heavy and chemical industry |
| IBRD | International Bank for Reconstruction and Development |
| IDA | International Development Association |
| IDB | Inter-American Development Bank |
| IFC | International Finance Corporation |
| IFI | international financial institution |
| ICA | international commodity agreement |
| IMF | International Monetary Fund |
| MDB | multilateral development bank |
| MFN | most favoured nation |
| ODA | official development assistance |
| OECD | Organization for Economic Co-operation and Development |
| OEM | original equipment manufacturing |
| OPEC | Organization of Petroleum Exporting Countries |
| PTI | Programme of Targeted Interventions |
| R&D | research and development |
| SAF | Structural Adjustment Facility (IMF) |
| SDR | Special Drawing Right |
| SITC | Standard International Trade Classification |
| SSA | sub-Saharan Africa |
| STABEX | system for the stabilization of export earnings (European Community) |
| SYSMIN | special financing facility for mining products (European Community) |
| TFP | total factor productivity |
| UNCTAD | United Nations Conference on Trade and Development |
| UNCED | United Nations Conference on Environment and Development |
| UNDP | United Nations Development Programme |
| WDR | World Development Report |
| WIDER | World Institute for Development Economics Research |

# About the authors


- **Louis Emmerij,** Special Advisor to the President, Inter-American Development Bank.

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- **Donald R. Lessard,** Professor of International Management at the Sloan School of Management, Massachusetts Institute of Technology, Cambridge, USA.

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- **Alfred Maizels**, Senior Fellow, Queen Elizabeth House, University of Oxford, U.K.

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- **Nguyuru H.I. Lipumba,** Professor of Economics, University of Dar-es-Salaam.

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- **Göran Ohlin**, former Assistant Secretary-General for Development Research and Policy Analysis, United Nations.

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- **Robert Wade**, Fellow, Institute of Development Studies, University of Sussex, U.K.


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# Introduction

The Intergovernmental Group of Twenty-Four on International Monetary Affairs (G-24) was established in November 1971 to increase the negotiating strength of the developing countries in discussions that were going on at that time in the International Monetary Fund on reform of the international monetary system. Developing countries felt that they should play a meaningful role in decisions about the system, and that the effectiveness of that role would be enhanced if they were to meet regularly as a group, as the developed countries had been doing for some time in the Group of Ten (G-10).

It soon became apparent that the G-24 was in need of technical support and analysis relating to the issues arising for discussion in the Fund and Bank, including the Interim and Development Committees. In response to representations by the Chairman of the G-24 to the Secretary-General of the United Nations Conference on Trade and Development (UNCTAD), and following discussions between UNCTAD and the United Nations Development Programme (UNDP), the latter agreed in 1975 to establish a project to provide the technical support that the G-24 had requested. This was to take the form, principally, of analytical papers prepared by competent experts on issues currently under consideration in the fields of international money and finance.

Mr. Sidney Dell, a former Director in UNCTAD's Money, Finance and Development Division and subsequently Assistant Administrator of UNDP headed the project from its establishment until 1990. During this period, some 60 research papers were prepared by the Group of Twenty-Four. The high quality of this work was recognized by the Deputies and Ministers of the Group and the reports were given wide currency, some being published in five volumes by North-Holland Press and others by the United Nations.

The project work was resumed in 1990 under the direction of Professor G.K. Helleiner, Professor of Economics, University of Toronto, Toronto, Canada. The UNCTAD secretariat continues to provide both substantive and administrative backstopping to the project. Funding is currently being provided by the G-24 countries themselves, the International Development Research Council of Canada and the Government of the Netherlands. As a result, it has been possible to continue to provide the Group of Twenty-Four timely and challenging analyses. These studies are being reissued periodically in compendia. This is the fifth volume to be published.

# THE NEGATIVE NET TRANSFERS OF THE WORLD BANK

**Göran Ohlin**


### *Abstract*

*In the course of the 1980s, IBRD lending slowed down very sharply and was overtaken by repayments and interest on its portfolio. As a result the net transfer from the IBRD abruptly turned negative, dropping from some $3 billion in 1984 to a negative $4-5 billion by the turn of the decade. Net transfers from IDA, which so far has few reflows, remain around $4 billion, but the combined net transfer from IBRD and IDA is negative, for the first time in the history of the World Bank. This contributed to the sharp swing in the overall net transfer to developing countries in the mid-1980s, which was a consequence of the cessation of private lending after the outbreak of the debt crisis. The consequence of an abrupt decline in the net transfer, which is the cash flow on financial account, is an immediate need for adjustment of trade balances and major shifts in the real economy.*

*Although IBRD lending slowed dramatically after 1982, its share in long-term financial flows to developing countries doubled. The reasons for the slowdown seem to include some weakening of demand, but above all the rise of cumbersome macroeconomic conditionality in adjustment lending and a host of new objectives and conditions relating to environmental protection, poverty alleviation, privatization, and other concerns. The Bank's own plans for lending to major borrowers were not met, which suggests unanticipated implementation problems. Given the great disparities in economic size among Bank members, what happens to a few large countries will dominate the Bank's accounts, sometimes deflecting attention from the large number of smaller borrowers.*

*Present policy seems to anticipate a continued decline in lending to traditional borrowers, possibly offset by new demands in Eastern Europe and the former Soviet Union. If IBRD lending resumes at a rate higher than the rate of interest on its portfolio, the net transfer from the Bank will slowly move up.*


## Background

In the course of the 1980s, the net lending of the IBRD stopped growing and began to decline. The net transfer - i.e. net lending less interest received - not only stopped growing but turned negative in the second half of the 1980s. As figure 1 shows, this was a very sharp break from the earlier trend. The net transfer had been close to $3 billion in 1984 but it dropped to a negative $5 billion in 1991.

IDA has very small reflows, and the net transfers of IDA are around $4 billion and growing. But with IBRD transfers negative to the tune of $5 billion or more, the combined net transfer of IBRD and IDA is also negative, which has never been the case before in the history of the World Bank.

The present paper discusses the reasons for this change and its implications. In the case of the World Bank, the switch to a negative net transfer is simply the consequence of the marked slowdown in IBRD lending in the 1980s and early 1990s. This is obviously an important development. Whether the changes in the net transfer deserve attention *per se* is less clear. It is not the mandate of the World Bank to maintain a positive net transfer to its borrowers, whether individually or collectively. But the net transfer concept is a source of frequent confusion, and an attempt will be made to discuss when it is significant and why (see annex).

For the most part the following paper is only concerned with IBRD lending, but for some purposes the evidence available relates to combined IBRD/IDA activities.

## I. The logic of the net transfer

Loans are meant to be paid back and they usually are; interest is also paid on the outstanding debt. At any given time there will thus be financial flows and reflows between lenders and borrowers. The net transfer is the balance of these flows. The new flows are present disbursements, but the reflows depend on the loans of the past and the terms for their repayment, so the net transfer will depend on both the past and the present.

The definition and relevance of the net transfer depends on the context, according to the choice of debtors and creditors whose past and present relationships are under consideration. It can be seen either from the borrower's or the lender's point of view. One also frequently includes sources of foreign capital other than borrowing, such as official development assistance (ODA) or direct foreign investment; in the latter case the reflows take the form of dividends. In the case of a single loan, it is obvious that there will be a positive transfer to the borrower during the disbursement period, and then a sudden shift to a negative transfer during the repayment period.

The most widely used concepts of the net transfer apply to a country as an accounting unit and to all its donors and creditors. Different variants are in use in different international organizations. One is derived from national accounting and balance-of-payments concepts. The net transfer of *real* resources may also be taken to include the changes in national welfare that result from changes in terms of trade, which in the case of commodity producing countries can overshadow other external and internal shocks. However, the simplest notion of the net transfer is the financial one already alluded to, i.e. the net cash flow resulting from new capital inflows and outflows of investment income.[1] This is the one adopted in World Bank statistical presentations, and it is the one used in this paper.

In the case of an individual country the chief interest of the net transfer is that, apart from changes in foreign reserves, it is the mirror image of the trade balance. If there is a sudden drop in the net transfer, and if the foreign debt is to be serviced, imports (and/or reserves) have to be drawn down or exports increased. To achieve such a shift of real resources rapidly can be difficult and painful. From this point of view the level of the net transfer is less important than sudden and disruptive changes.

For the net transfer to a country to remain positive, net new lending must exceed the interest on the old debt. That is another way of saying that the rate of growth of the debt must be greater han the average rate of interest on the old debt. f the rate of interest exceeds the rate of growth of underlying economic aggregates out of which debt is to be serviced, such as national product or export earnings, a continued positive net transfer to a country will result in a deterioration of the indicators by which the riskiness of the debt is assessed. In the end such a transfer will not be sustainable.

Another implication, which may not be immediately obvious, is that if the growth of the debt drops below the rate of interest, the net transfer will not just slow down - it will shift abruptly from positive to negative. Considering the necessary adjustments in the real economy,

such volatility can be a major hazard (Ohlin,1968, p. 47).

The repayment obligations on past loans have an inexorable momentum, and if new borrowing slows down, the result will resemble that of a tugboat which stops dead in the water while the barge that it has been pulling crashes into it. One objective of debt management is to avoid abrupt swings in the net transfer. It is common and natural to look at the total net transfer to an individual country, but there is less reason to add up the net transfers to groups of countries, such as all developing countries. They are not a joint financial unit, and they are not responsible for one another's debts.

In the case of individual creditors in a market with many lenders and many borrowers, the net transfer is the cash flow to the debtors, individually or collectively. If the combined net transfer to all borrowers goes in their direction, that cash flow must be offset by a net transfer to the lender in the other direction. A middleman such as the World Bank must balance its net transfers towards its borrowers against cash flows from its financing activities or its operational activities and management of its own capital.

## II. Net transfers in a broader perspective

The net transfer to developing countries had been sporadically referred to for many decades, usually with the polemical purpose of belittling the financial flows to these countries. However, in the 1980s it came to attract more general attention, as the net transfer to all developing countries suddenly turned negative (table 1).

Between 1983 and 1984 there was a drop of $40 billion dollars. This was a manifestation of the international debt crisis, the abrupt cessation of bank lending, in particular to Latin America, and extensive capital flight. Since the net transfers in table 1 include official development assistance (ODA), which is largely on a grant basis, net transfers to Africa remained positive, although they too declined.

***Table 1***

**NET TRANSFER TO ALL DEVELOPING COUNTRIES**
*($ billion)*

| | | | |
|---|---|---|---|
| 1982 | 34 | 1988 | -15 |
| 1983 | 18 | 1989 | -25 |
| 1984 | -23 | 1990 | -25 |
| 1985 | -10 | 1991 | 47 |
| 1986 | 19 | 1992 | 52 |
| 1987 | -28 | | |

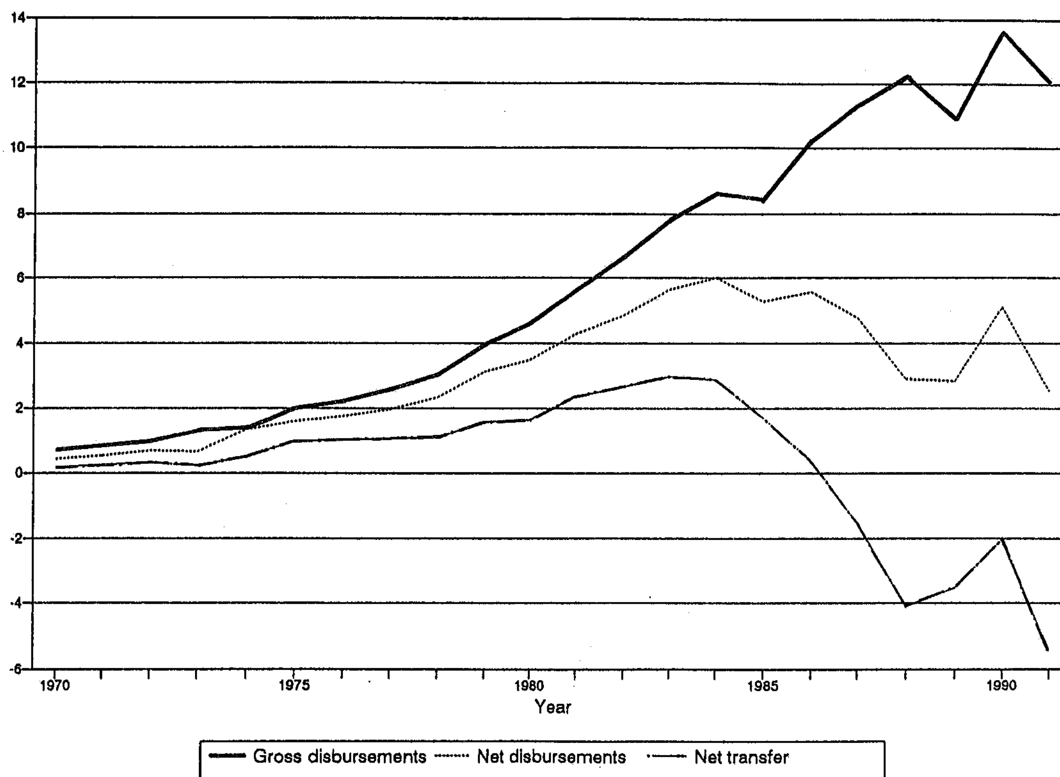
***Source:*** United Nations, *World Economic Survey 1993*, table IV.I.

The net negative transfers in the 1980s caused much heated comment and a considerable amount of misinformed confusion. The net transfer was frequently taken to represent a net capital flow, and it was common to hear that things had come to the point where poor countries were financing the rich.

There was also sometimes an indignant presumption that there should always be a net transfer to developing countries in order to help them to import more than they exported. Behind this presumption there is the old idea that countries in the course of their development should be capital importers until they mature and become capital exporters. This, however, does not mean that they should receive positive net transfers, borrowing more than they pay in interest and dividends. Latin America has received foreign capital and foreign investment for a very long time, and has long had net negative transfers. If export performance and the returns on the use of foreign resources are adequate, foreign debts and investments can be serviced without the aid of new loans.

A positive net transfer is not essential to the operation of a national economy or any organization. Large transnational corporations, for instance, tend to pay much more in interest than they add to their debt. Countries can be managed quite well with any level of net transfers, positive or negative, provided that they are stable.

*Figure 1*




What really mattered in the 1980s was the abruptness of the crunch due to the debt crisis, which faced many countries with severe adjustment problems, a number of which still linger. In this sense, the change in net transfers was essentially a symptom or a measure of the convulsions in the world economy and of the external shocks to which many countries were exposed. Sharp swings in the flow of credit are bound to be disruptive; among other things, they will be magnified in the net transfer and force wrenching adjustments in the trade balance.

With the return of flight capital and creditworthiness in many countries in the early 1990s, there was an equally abrupt reversal, again focused on Latin America. This time it caused another set of disruptions, as financial inflows tended to push currencies into overvaluation.

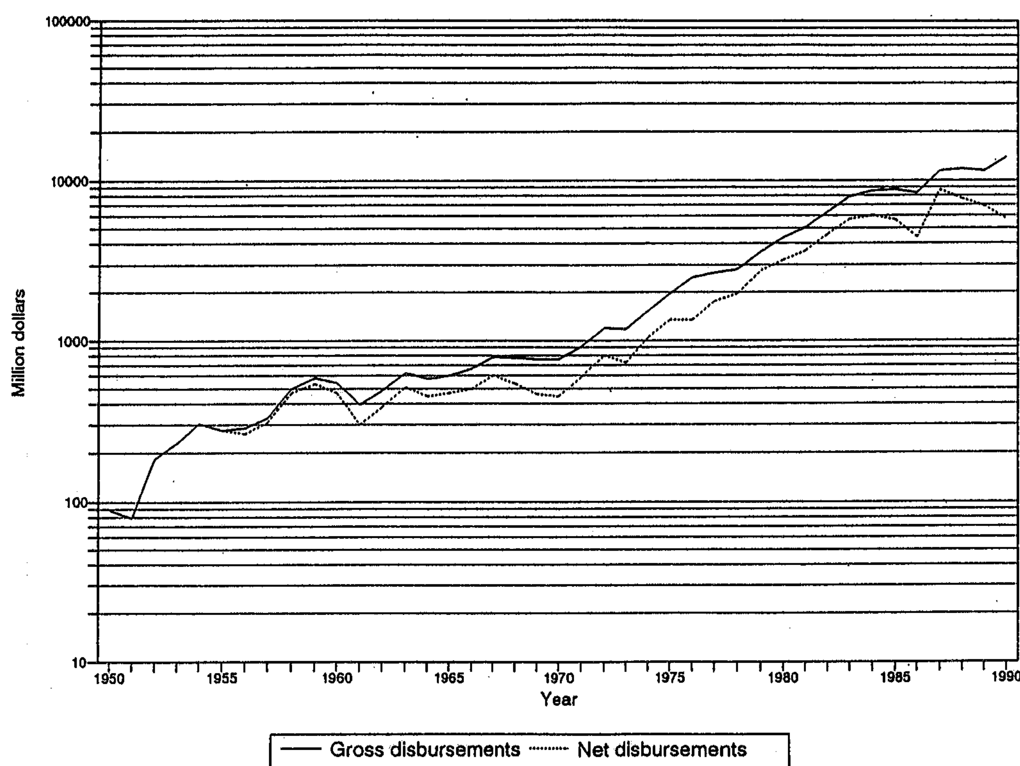
Against this background, how important was the drop in IBRD's net transfer in the mid-1980s? It clearly did not serve to counter the contraction which, based on some interpretations of the World Bank's role, could have been a natural objective. Instead it contributed some $8 billion to the overall contraction of $40 billion.

## III. The stagnation in IBRD lending

Returning to the development of World Bank lending, a retrospective look shows pronounced cycles in its growth over the half-century of the Bank's existence. Figure 2 shows the gross and net disbursements on a logarithmic scale where the slope of the curve reveals the growth rate. The average annual rate of growth of gross disbursements has fluctuated from decade to decade.

*Figure 2*

**IBRD DISBURSEMENTS, 1947-1991**
*(Logarithmic scale)*




In the 1950s gross disbursements grew at an average annual rate of 20.0 per cent. When disbursements slowed down in the 1960s (to 3.3 per cent annually), the reflows from past lending caught up with new loans very quickly. The then president of the Bank, George Woods, said at the annual meeting in 1965: "To go on doing what we are doing will, in the not too long run, amount on balance to doing nothing at all" (World Bank, 1965, p. 11). That statement seems to imply that the mission of the Bank was to enhance the import capacity of developing countries, which made good sense at the time.

When Robert McNamara became president, he set the goal of doubling the Bank's lending in five years, and the surge of new lending in the 1970s lifted disbursements and net transfers from the World Bank to a steep growth path. Gross disbursements grew at an average annual rate of 19.2 per cent. But in the 1980s the rate of growth of gross disbursements dropped again, to 4.8 per cent (figure 3). Around 1987-1988 it fell below the interest rate on the old debt. The growth of the outstanding debt slowed too, so the net transfer turned negative as already seen in figure 1. Although there was a significant increase in interest rates, figure 3 makes it clear that it was the slowdown in lending that mattered.

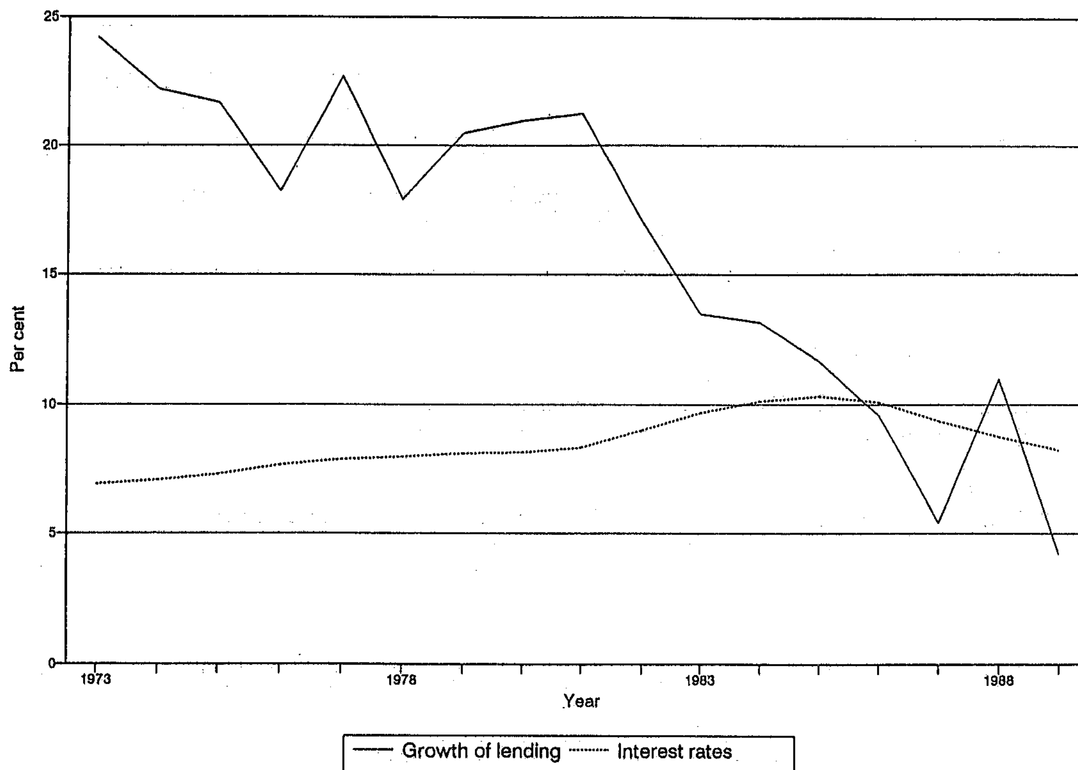
In constant dollars, IBRD commitments tripled between FY1973 and FY1982. They then remained almost flat, slightly above $16 billion (in 1992 dollars) between FY1982 and FY1992. In current dollars there was a five-fold increase in the former period, and then a levelling off.

This dramatic slowdown in the growth of IBRD lending in the 1980s and the flattening out in the early 1990s has attracted much attention but it is not easily attributable to any single factor, least of all a deliberate policy decision. The

***Figure 3***

**RATE OF GROWTH, IBRD DISBURSEMENTS**

*(Five-year moving averages)*




***Note:*** The 5-year moving average for the growth of gross disbursements is centred on the year itself. The interest rate is the average of the IBRD lending rate for the previous five years, which is used as a proxy for the average interest on outstanding debt.

drastic changes in the world economy, the debt crises in developing countries, the new emphasis on policy conditionality, the reorganization of the World Bank in 1987, and a generally prudent and cautious management - all seem to have contributed in varying degrees. Generally speaking, IBRD does not seem to have been constrained by capital shortage, especially not in recent years. The "headroom", i.e. the permissible increase of net disbursements, is very substantial - at the end of fiscal 1992 it was $68 billion or 40 per cent of IBRD's lending limit (World Bank, 1992a, p. 74).

The slowdown was discussed in considerable detail in an internal paper for Executive Directors in 1992, entitled "Factors affecting IBRD lending in the eighties and implications for the nineties" (World Bank, 1992b), to which frequent reference will be made.

The sharp break in the trend of IBRD lending was welcomed from the start by those who saw it as a necessary breathing space, a consolidation after an unsustainably rapid expansion (for example, George Schultz quoted in Shapley, 1993, p. 564). In the view of many critics, the quality of projects had declined and the Bank had ventured into development finance of a kind that even some staff members did not think particularly bankable.

However, it is worth noting that in the 1970s World Bank lending grew no more rapidly than

other gross flows to developing countries and that the IBRD share remained unchanged at about 4 per cent (World Bank, 1992b). In the 1980s, on the other hand, private flows shrivelled and although Bank lending stagnated its share in total financial flows doubled.

Another frequent explanation of the shifting of gears at the Bank is that it had become a "maturing financial institution". It is not entirely clear what is meant by this, but it usually seems to imply that repayments must catch up with new lending and that the Bank must settle down to being a revolving fund which does not continually contribute net cash flows to developing countries or other clients. This is a simple and appealing notion, but by itself it does not make much sense. The Bank could be said to have matured in the 1960s but it was then turned into a dynamic development agency. In its future growth it may be threatened by senescence and bureaucratic rigidity, but if stockholders and management wish for the Bank to expand, it is hard to see any laws of financial maturity that would hold it back.

Superficial discussions of IBRD lending all too easily give the impression that its member borrowers form one homogeneous body, which is of course not the case. Looking at the situation from its borrowing members point of view, the question of net lending and net transfer looks rather different.

## IV. Individual borrowers

The overall trends in IBRD lending are not of primary interest to individual borrowing countries; they are not responsible for the repayment of the loans of other countries. Of course, an expansive stance on the part of the Bank will enhance the likelihood of new loans, but this is only one aspect of the financial situation of an individual country.

Few countries are big enough to borrow steadily from the Bank and to have a sustained positive transfer over a longer period, even in times of expansion. Borrowers will either be in a disbursement phase, with positive transfers from IBRD, or in a repayment phase in which the net transfers will be negative. So far, IDA countries have few reflows, and their net transfers tend to be positive. Figure 4 shows the distribution of combined IBRD and IDA net transfers in 1984 and 1989. It brings out the fact that most countries had rather modest net transfers to or from the Bank, below $100 million. This is a reflection of the fact that most Bank members are small countries. However, between 1984, when the combined net transfer was $6.8 billion from the Bank (IBRD and IDA), and 1989, when it was $450 million to the Bank, there was an increase in the number of countries with negative transfers, and a drop in the number of countries with positive transfers.

But the number of countries gives a misleading impression: Countries with very large transfers one way or the other are very few, but they account for a dominant part of the Bank's business. Figure 5 shows the combined net transfers in 1989 by the volume in each group rather than the number of countries. China and India had substantial positive transfers, and a small number of other countries (Brazil, Indonesia, Republic of Korea, Thailand, Turkey) very large negative ones.

At any point in time, a lending institution will obviously have a cash flow to new customers and a cash flow from old ones, at times small and at times very large. When IBRD moved from a positive net transfer to a negative one in the late 1980s, the implication was that more of its clients had fallen into the repayment mode. This should not, as the Wappenhans report has insisted, reduce the Bank's interest in the follow-up of the projects and the management of the Bank's portfolio, but it does switch the cash flows.

## V. External factors in the slowdown

In the 1980s, the international recession and the debt crises made adjustment policies a far

*Figure 4*

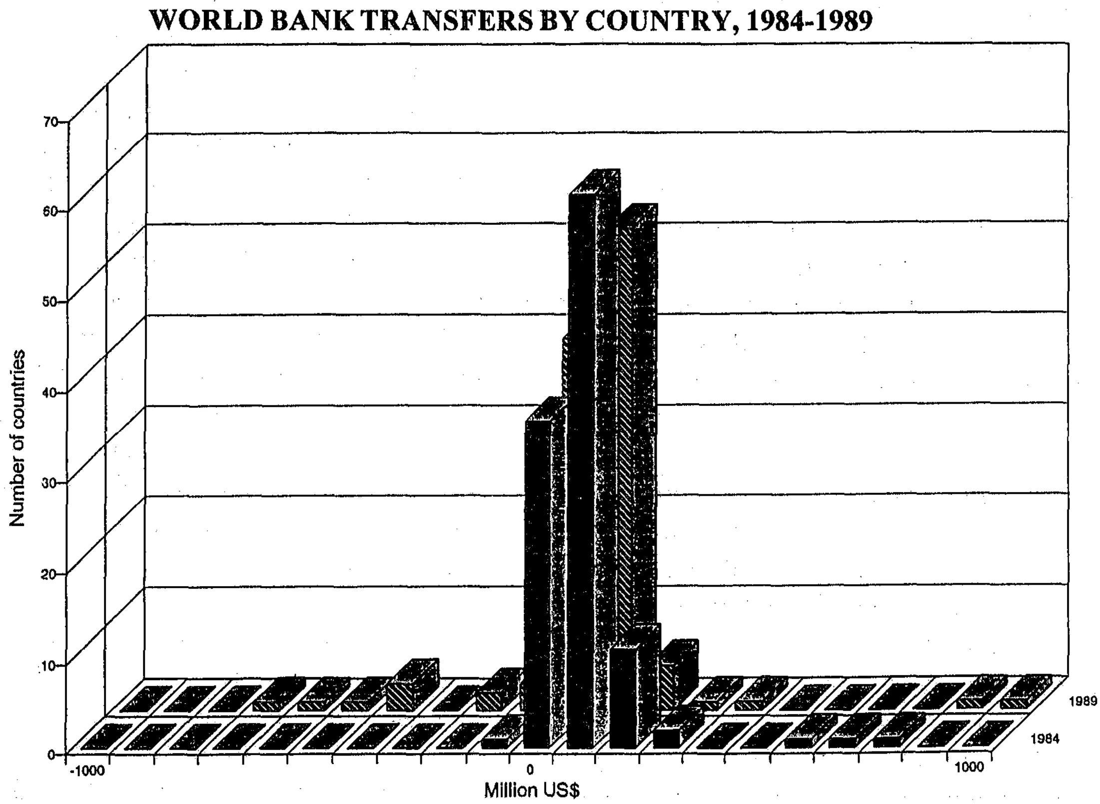
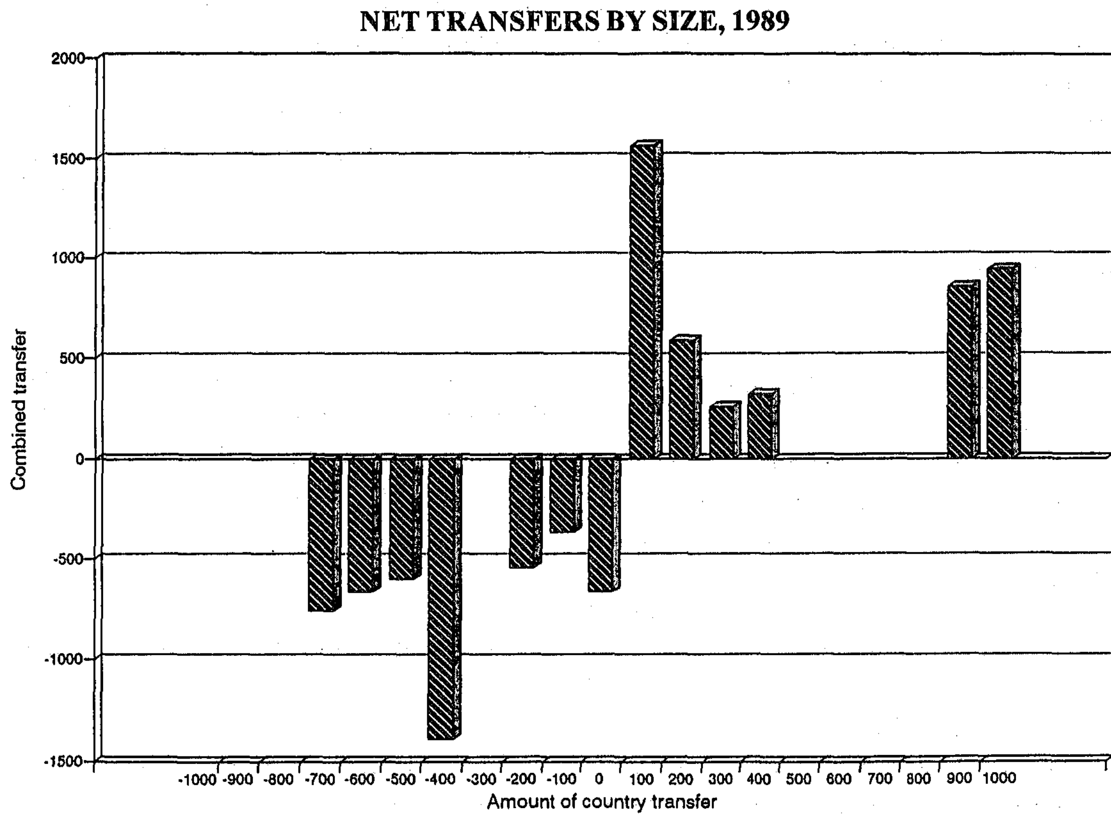



*Figure 5*



more central concern in Bank operations. In addition, political and economic instability turned some members into so-called "hiatus countries" (El Salvador, Iran, Iraq, Panama, Paraguay, Peru, Romania, Syria, Trinidad and Tobago). On the other hand, new borrowers appeared - China and Hungary in the early 1980s, other Eastern European countries and Russia only towards the end of the decade and the early 1990s. These developments tended to offset one another, though the balance was an increase of the annual commitment level of some $2 billion, and of gross disbursements to China and Hungary of some $1 billion.

Lending to the old borrowers did not grow much in real terms between 1982 and 1990; thereafter commitments declined sharply, from some $14 billion to $10 billion in 1992 (World Bank, 1992b, p. 5). Almost all of this decline seems to have been in a small group of large countries - Algeria, Argentina, Brazil, China, India, Nigeria, Turkey, and Yugoslavia. Lending to these countries also fell dramatically short of the annual lending plans which set country levels for the coming three years. For 1990-1992, planned lending to them had been set at close to $30 billion; the actual was no more than $16. This suggests that unanticipated difficulties of implementation arose, but it does not by itself say much about the reasons for this difference.

The Bank staff analysis groups most of these countries together with "late adjustors" which failed to restore fiscal balance and achieve macroeconomic reforms while suffering sustained low investment, weak export performance, slow growth, worsening credit worthiness and little access to private external finance. It is suggested that the flagging of the reform programmes and the lack of investment recovery would explain why Bank lending to these countries flattened and declined in the course of the 1980s. In addition, debt service indicators deteriorated quite sharply in the course of the decade. Given their high levels of indebtedness this should have made many countries hesitate to borrow from any sources; a number of countries also exceeded the guidelines set by the Bank for debt-to-export earnings, the IBRD share in public debt service, and the share of preferred creditors in public debt service. Whether or not this deterred the Bank from more lending is difficult to know; given the radically changed international situation, there would have been a case for reconsidering traditional guidelines, but clearly the Bank's portfolio was coming to appear much riskier as heavily indebted countries assumed a larger role.

The crises of the 1980s also affected the projects under implementation and contributed to the decline in performance that has been highlighted in the recent Wappenhans report. This may be a reason for the slowdown in disbursements and the increase in undisbursed balances which by 1990 had risen to almost $50 billion. On the other hand, the small group of "early adjustors" (Chile, Republic of Korea, Malaysia, Mauritius, Thailand) quickly restored fiscal balance, growing investment and exports, and access to private financing which allowed them to draw down their borrowing from official sources, including the IBRD.

From this standpoint, country policy was highly significant, or even decisive: When it was successful it reduced the demand for Bank finance, and when it was unsuccessful it reduced both the demand and the Bank's willingness or ability to supply it. However, there were also major changes in the World Bank itself which affected internal procedures and relations with borrowers.

## VI. IBRD lending practices

By the beginning of the 1980s the call for more flexible finance than the Bank's traditional investment loans had grown very strong and the Bank launched sectoral programme loans. With the turmoil of recession and debt crises, adjustment lending began on a large scale. One of the chief objectives of the advocates of programme lending had been fast disbursement, but the outcome was policy conditionality which

delayed loan agreements.

One indication of the change in the Bank's practices is the number of loans per year, which doubled between 1973 and the early 1980s when it was close to 150, then dropped to about 120 in the early 1990s. The average size of loans increased steadily, because adjustment loans were much bigger than investment loans,[2] and because investment loans, too, became bigger even in real terms. But the overall result was slower commitments. The Bank staff report argues that policy disagreements were behind the drops in lending to major borrowers, and that:

> ... the timing of this change makes it probable that it was directly related to the greater country program (rather than project) focus after the 1987 reorganization, the stronger economic policy orientation of the new Country Directors and a more systematic senior management focus on good country performance (World Bank, 1992b, p. 33).

A related point made in many reports and discussions is that new policy objectives in such areas as environmental protection, poverty reduction and other social issues, and private sector development have made lending operations vastly more complex. The Bank report concludes:

> Overall, it is likely that the increased policy focus in an expanding number of areas during the 1980s, and especially after the 1987 reorganization, contributed to a more conservative lending stance than was the case in the 1970s (World Bank, 1992b, pp. 33-34).

The role of such problems with major borrowers is highlighted in the *Annual Report 1992* which explains the drop of commitments below the 1991 level as due to delays by India and Pakistan in adopting reform programmes, delays of projects in Central and Eastern Europe, and similar delays in large operations in Algeria and Egypt (World Bank 1992a, pp. 18-19).

Exposure factors seem to have played a limited role in restraining Bank lending, and staffing and budget do not seem to have been a binding constraint. In fact, the operational budget increased by 35 per cent in real terms, while combined IBRD and IDA lending rose by 20 per cent and the number of lending operations declined by 9 per cent.

## VII. Switches to other sources of finance

As already mentioned, some countries have gained access to private capital markets and reduced their borrowing from IBRD or regional development banks. Some, notably in East Asia, have received large concessional flows from Japan and have reduced their dependence on IBRD.

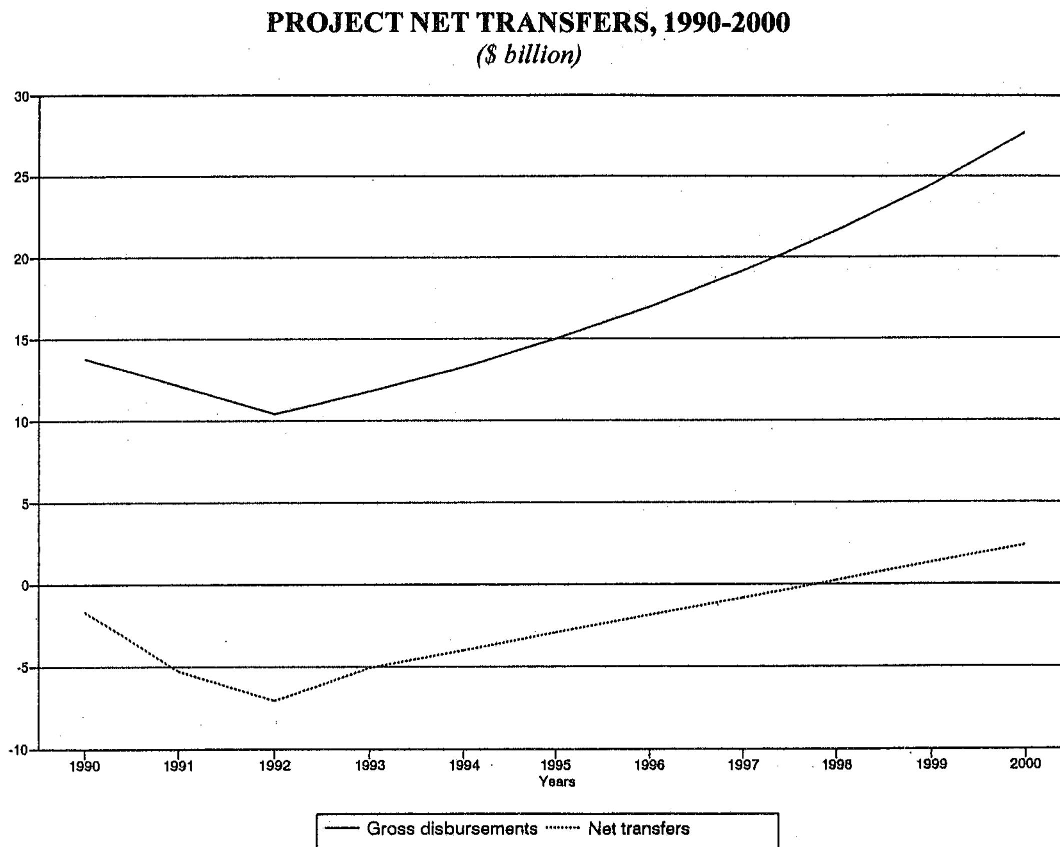
A few countries have in recent years prepaid their loans to the IBRD. This has been generally encouraged by the Bank, which has waived its premiums according to an established schedule. However, the bulk of prepayments so far involves only Romania, a very special case; the Republic of Korea, which with great surpluses went in for radical debt management; and Thailand, which received much concessional finance from Japan. But prepayment, which in 1987-1992 amounted to $5.8 billion, seems a very marginal element in the switch of borrowers to other sources of finance.

When countries graduate to other sources of finance this is of course in line with the original mandate of the World Bank. However, it does not mean immediate access to long-term credit, and if members turn to other sources because they are impatient with cumbersome conditionality and slow and costly procedures in the Bank, one may wonder if there should not also be a process of graduation in the Bank itself.

## VIII. Prospects

In principle, the opportunities for investment and project lending both to the Bank's old clients and to the new members in Eastern Europe and

***Figure 6***




the former Soviet Union should be very great. There is certainly a vast need for infrastructure in power, urbanization, telecommunications, environment, etc. However, disputes over macroeconomic policies and sectoral conditionalities may well continue to hold up lending to some very large countries.

The present policy stance of the Bank seems to be one of accepting a stagnation or even decline in its lending to traditional borrowers among developing countries, while anticipating a substantial demand from Eastern Europe and the former Soviet Union where activities have so far been slow to mature but might become sizeable. One consequence of this would seem to be that traditional developing countries will move into a repayment mode while new clients in the East will be in a disbursement mode.

For developing countries this outlook is not worrisome if they do not need or want more World Bank loans, and if they are doing well enough to service their old debts without difficulty. But if they are caught up in policy negotiations which delay new commitments and disbursements while their old obligations are ticking away, the net transfers to IBRD become a painful reality.

## IX. Projected IBRD net transfers

As in the past, IBRD net transfers in the future will be determined by the rate of new lending and disbursements, as the Bank has a substantial portfolio and scheduled reflows. The present policy signals suggest greater and no doubt welcome attention to the outstanding portfolio rather than forceful expansion. If commitments

and disbursements grow fast enough, net transfers will stop declining and increase again, but if the new lending moves East rather than South, the overall numbers will contain more negatives in the South and positives in the East.

All that the projection in figure 6 really shows is the inertia of a big portfolio. It is assumed that gross disbursements will grow by 13 per cent and that the average rate of interest on past debt will remain about 8 per cent. On these assumptions, the Bank's net transfer would become positive again around 1997 and regain its mid-1980 levels by the end of the century. Needless to say, even small changes in the assumptions about the growth of gross lending would change the outcome.

## Conclusions

The concern over the swing towards a negative net transfer from the World Bank should be directed toward the slowdown in IBRD lending and disbursements, which has numerous and complex causes that largely fall beyond the scope of this paper. Some are external to the Bank, others seem related to its basic policy stance and the complexity arising from the new conditionalities introduced in the 1980s. These issues also concern the future role of the Bank in a world where development in the South is by no means assured everywhere although new needs for reconstruction and development have emerged.

## *Notes*

1 For an extensive discussion of the derivation of these concepts and their use by the United Nations, the OECD and the World Bank, see United Nations (1990), pp. 79-81.

2 Investment loans, in the Bank's terminology, include project loans, sector investment loans, financial intermediation loans, emergency reconstruction loans and technical assistance loans.

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## *Annex*

### Why call it "net transfer"?

The concept of "net transfer" has been controversial and misunderstood since it was introduced in the 1960s. Economic terminology is frequently confusing, because the same words mean different things in different contexts. "Investment" is perhaps the most common, and "transfer" is another of those words. In legal or financial situations everybody understands the meaning of transferring funds or transferring ownership, but in the terminology of national accounts the word is used in a narrower sense, referring only to movements of money which have no counterpart in goods or services, such as gifts or welfare grants. This is carried over to foreign aid, and in balance of payments accounts both official grants and migrants' remittances are entered under the heading of "transfers". Such transfers enable a receiving country to import more, export less, or add to its foreign exchange reserves.

However, if inflows of foreign aid or foreign capital take the form of loans or investments, they give rise to later reflows in the form of interest payments or dividends. The cash flow from foreign financial transactions will depend both on new inflows and on the obligation to service the debt which past loans have created. The notion of "net transfer" was introduced in the 1960s to draw attention to this dimension of external finance. It ran into opposition from balance-of-payments theorists who made a sharp distinction between the current account and the capital account: Repayments of old loans fell in the capital accounts but interest payments were rewards for the use of foreign capital and belonged, like other factor services, in the current accounts.

Yet repayments and interest payments were both made in money, and the theoretical distinction was irrelevant to policy makers who had to cope with fluctuations in the cash flow from the financial side imposing a restructuring of their economies which was sometimes radical, sometimes impossible.

In the political debate there was a tendency to confuse net transfers with capital flows, and to argue that developing countries with net negative transfers were exporting capital to rich debtor countries when they were, in fact, paying interest on past loans.

Nonetheless, in the 1980s, the net transfer became a more accepted concept. But it also began to stray far from its origin which was that of the analysis of the balance of payments of a developing country relying on external capital inflows.

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# A CRITICAL REVIEW OF THE WORLD BANK'S APPROACH TO SOCIAL-SECTOR LENDING AND POVERTY ALLEVIATION

**Louis Emmerij**

***Abstract***

*In 1990 the World Bank returned to the human-resources and poverty-reduction focus which had characterized much of its work during the 1970s. It proposed a two-part strategy, a more labour-intensive growth pattern and better access for the poor to social services. It also recommended targeted interventions and safety nets for those who would not (yet) benefit from the strategy. The Bank has been serious and rapid in producing "implementation reports" with a view to incorporating social and poverty reduction objectives into its day-to-day lending practice. After three years it is now already possible to give a first indication as to whether the Bank has taken the right direction on the road to a more employment-intensive development strategy for shortening the transition period at the end of which everyone would reach a level of income above the absolute poverty level.*

*A close study of the Bank's own recent first evaluation reveals that the first part of the strategy - a pattern of growth that is more labour intensive - has not received the attention it deserves. As for the second part of the strategy, the Bank has not formulated a social reform policy which is integrated into its financial and economic reform policies, with a clear definition of the social sector and specified priorities. In practice, emphasis is on education, population, health and nutrition. Agriculture and rural development appear to be ignored; only lip-service is paid to land reform. Urban development has not been classified under the "poverty-focused" sectors, although it is precisely here that some of the more interesting and relevant thinking and practice is going on.*

*In practice, therefore, the Bank acts as if economic growth plus education will be sufficient to make a significant dent on poverty as well as improve the social climate. In theory, it knows that this is wrong. Our deduction that the Bank's declared intentions are only very partially implemented is confirmed by studying the actual lending projects approved in fiscal 1992.*

*The priorities of Governments, institutions and individuals must be judged not according to the lip-service they pay to one objective or another, but according to where they put their money. Taking this as a criterion, so far the Bank is long on words and short on deeds.*

## Introduction

In the *World Development Report 1990* the World Bank addressed the poverty issue for the first time since 1980 - the end of the McNamara era (World Bank, 1990). This was significant because it seemed to herald the end of the 1980s with its relative neglect of the social sectors in general, and the poverty reduction objective in particular. The *World Development Report (WDR) 1990* was convincing in its intention that the World Bank should once again address the poverty problem directly, since the reduction of the number of people living in absolute poverty remains a central objective of economic growth and development.

Now, three years later, would seem to be a good time to take stock of the efforts the World Bank has made since 1990 to steer its "machine" in the direction indicated by the *WDR*. It must be stated at the outset that the World Bank, to its credit, has not waited for "outsiders" to do this, but has taken itself the initiative of preparing an initial evaluation (World Bank, 1993).

This valuable publication will be put to good use in this paper, which represents an attempt to review the effectiveness and shortfalls of the World Bank's approach to social-sector lending and poverty reduction. The terms of reference on which it is based are:

(1) Has the World Bank successfully integrated poverty as a first-order priority objective in its actual lending practice?

(2) Do the modalities of actual practice agree with the Bank's stated objective, and are the proposals contained in its own *Poverty Reduction Handbook* carried forward?

(3) What is the practice followed in adjustment lending and in more directed social-sector activities such as education and health?

(4) What are now the "best practice" procedures and loans, and how do they contrast with the inadequate approaches still to be found?

(5) In sum: what improvements have been made over the past three years?

This paper is divided into three main parts, followed by a short concluding section. Part I discusses the renewed interest in poverty and how this is reflected in the declared intentions of the World Bank. In Part II, the progress towards these declared intentions is reviewed, based on the World Bank's own reports and analyses. Part III will take a critical look at the record established by the Bank and review the data base; emphasis is on the pattern of development versus economic growth and on social sectors versus social reform, safety nets, social security, etc. The concluding remarks revert back to the terms of reference of this study.

## I. The renewed interest in questions of social policy and poverty reduction

The wheel has once again turned from an almost exclusive emphasis on economic growth to a more comprehensive set of economic and social objectives, including poverty reduction. It remains a source of amazement to observe this continuous swinging of the pendulum with so little being learned from experience. Indeed, experience should have taught us long ago that high rates of economic growth are a necessary but insufficient condition for achieving social objectives such as the creation of higher rates of productive employment, poverty reduction, the provision of high-quality education and health services, the maintenance of the quality of life in urban centres, etc.

Careful observation of the world economy should also have taught us that the sustained high rates of growth in East Asia did not bring about the full employment reached in the early 1970s (the case of the Republic of Korea, for instance). On the contrary, focus on the full utilization of the factors of production - and in the first place on labour - was the key to the high rates of growth observed in the East Asian development model.

Had development policies not been oriented toward employment, sustained rates of economic growth of 8 to 10 per cent would not have been possible. This same phenomenon can now be observed in China. In short, the lesson to be drawn from experience is that the pattern of growth matters at least as much as the rate of growth.

The pattern of growth is determined by emphasizing certain economic sectors, population groups, and income groups; it is furthermore affected by the role assigned to the quality of the human resources of a country, by assuring a regional balance leading to regional equity, and by giving people a say in their economic destiny. This lesson was learned once after the Second World War, as reflected in *WDR 1980* devoted to the question of poverty, just as its counterpart of 1990.

But in the decade between these two *Reports*, this lesson was all but forgotten. The world economic depression of the early 1980s, and the international debt crisis that began in 1982, resulted in the return to an economic paradigm of another age: "First obtain economic growth and everything else will follow". Gone was the lesson that a balanced and integrated set of economic, financial and social policies is essential for attaining not only growth, but also employment, a decent income, access to education, health, and clean drinking water for all - in short, that essential needs are satisfied for everyone. Gone also was the conviction that an "economic growth first" policy would, as a matter of course, result in more poverty, more uneven income distribution, and hence unavoidably in social unrest that could endanger the sustainability of economic growth.

In a sense, it is understandable that each generation, when confronted with an economic crisis, resorts to the old reflex of getting back to growth at any price. And "any price" now, as in earlier times, means growing income disparities, fewer income-earning opportunities, and less emphasis on the "soft" social sectors such as education and health. But what is less understandable is that during the 1980s the basic lesson of the previous two decades was forgotten, namely that the economic and the social were one, that they were complementary and mutually supporting, and that one without the other leads to disaster. Too much "social" without sufficient "economic" leads to bankruptcy and an end to growth; too much "economic" without sufficient "social" leads to social unrest and also to an end to growth. How could informed decision makers still talk about "soft sectors" more than 20 years after the renaissance of the economics of education and health which showed, convincingly, that education and health are investments in human capital, and hence a prerequisite for economic growth rather than a consumption good to be afforded only after a given level of economic achievement has been reached.

True, these lessons from experience were put forward, but their influence was not far-reaching (Cornia et al., 1987). Basically, the 1980s brought the return of the old sequence that has proven wrong again and again: growth first, distribution later; stop inflation first, create employment later; buy now, pay later; free trade now, industriali-zation later.

The results of this decade are now everywhere to be seen: the employment problem has become universal (close to 11 per cent open unemployment in the EEC); the misdirected development of the city has led to unacceptably low levels of quality of life practically everywhere; educational quality is endangered and health services everywhere direly need restructuring; social security and pension funds, where they exist, have become endangered species; increasing numbers of political and economic refugees are coming to Europe, which is still seen by people from the East and South as a haven of luxury despite economic stagnation and rising unemployment. In short, never has it been more true than today to say that "poverty anywhere is a threat to prosperity everywhere".

### *A. The World Development Report 1980*

In his Foreword to *WDR 1980* concerned with adjustment, poverty and human development, Robert McNamara, while stressing the need for adjustment, made it quite clear that "successful adjustment should not unduly sacrifice either the current living standards of the poor or the measures needed now to reduce poverty in the future. Growth is vital for poverty reduction, but it is not enough" (World Bank, 1980, p. iii).

The decade of the 1970s was not only the period of oil price hikes, but also of the pursuit of more effective development strategies in terms of productive employment creation, poverty reduction and meeting basic needs. The World Bank under McNamara was very active in this search for more employment-intensive and equitable economic and social policies, and the *WDR 1980*, coming at the very end of this period and at the beginning of a new era, was a reflection of these efforts.

*WDR 1980* contains a subtle discussion on the relationship between economic growth and poverty. It stated that there is a great deal of truth in the proposition that the solution to poverty is economic growth, but that, for a number of reasons, this proposition needs to be carefully qualified (World Bank, 1980, p. 35). First, there are countries which, because of differences in income distribution, have many more people below the poverty line than others at similar levels of development. Second, looking at changes over time within particular countries, the connection between growth and poverty reduction over a decade or two appears inexact. There is general agreement, *WDR 1980* maintains, that growth in the very long term eliminates most absolute poverty, but also that some people may (at least temporarily) be impoverished by development. Third, the connection between economic growth and poverty reduction is a two-way street: education, health and the quality of life are a cause as well as a result of development. Similarly, people who are unskilled and in ill health make little contribution to a country's economic growth. Development strategies that bypass large parts of the population may not be the most effective way for developing countries to raise their long-run growth rates. This is consistent with the point made earlier about the East Asian development model.

If, therefore, faster growth of average income is indeed essential to reducing absolute poverty, this is not enough if the length of the transition period matters. No one would deny that economic growth in the long run is effective in tackling poverty, but it might take three to five generations. In other words, the transition period would be humanly unacceptable and politically irresponsible. *WDR 1980* recognizes this and therefore considers that the *pattern* of growth is as important as the *rate* of growth. The pattern of growth comprises the range of measures that must be taken - in the context of strategies aimed at increasing average income - to raise the income of those in absolute poverty. In this connection, *WDR 1980* mentions land and land tenure; capital and credit; education, health and fertility; research and technology; migration; and transfers and subsidies.

On the issue of land and land tenure, WDR 1980 concludes that "despite the difficulties, land and land tenure reform (in urban as well as rural areas) remains a vital element of poverty reduction in many countries, and it merits strong support" (p. 41).

On capital and credit, *WDR 1980* notes that irrigation schemes raise the incomes of landless labourers, even though farmers (especially those who own their land) derive even greater benefits. Similarly, the building of roads that reach remote villages where some of the poorest people live have increased incomes by providing access to new seeds, insecticides and markets. The construction phase of infrastructural investments also provides employment and higher wages for the poor.

Productive employment creation is the most effective way to implement poverty-reduction programmes. The employment opportunities and earning power of the poor are limited by sickness, insufficient food and lack of education. Standards of living are also depressed by high fertility and

consequent large family size. While greater access to improved education, health and nutrition is obviously necessary to increase the earning power of the poor, this is not sufficient. Measures are needed to expand the demand for labour and to furnish the incentives and material resources required for innovation (p. 43).

According to *WDR 1980*, the role of science and technology in reducing poverty is particularly apparent in agriculture. The Green Revolution has improved the lives of poor consumers and (on balance, although with many exceptions) small farmers in the more rain-fed parts of Asia. More research is needed on dry farming and on the cultivation of poor soils and subsistence crops on which many low-income farmers depend. Industrial research typically concentrates on capital-intensive methods of large-scale production, and small enterprises are disadvantaged, job creation is limited, and "some of the goods bought by the poor are not improved or made cheaper as rapidly as those bought by the rich" (p. 44). More research could reduce these biases.

Migration of all types can have harmful social and economic effects. However, on balance, the evidence suggests that by enabling labour to be used where it is most productive, migration aids both growth and poverty reduction.

The possibilities for the use of transfers and subsidies in reducing poverty are more limited in the developing than in the industrial countries. In the former, productive employment policies are the main policy instrument.

In conclusion, *WDR 1980* was a true "bridging" effort between two periods, the 1970s and the 1980s. It anticipated the necessity of an adjustment effort during the 1980s and illustrated how this could be done without sacrificing the poor, or worse, creating more and "new" poor. It pointed out that the trade-off between poverty reduction and growth must not be exaggerated, especially from a narrowly economic point of view. "More support for agriculture, land reform, expansion of industrial employment, and a more even distribution of public services, can all help to reduce absolute poverty and accelerate growth. This Report similarly stresses not only what greater national income can do for the education, health and nutrition of the poor, but also how human development policies for the poor can contribute to raising national income" (p. 83).

Growth is vital to the reduction of all aspects of absolute poverty - malnutrition, ill health and illiteracy, as well as low income - especially in the poorest countries. But growth unaccompanied by other measures may neither boost significantly the income of the poor nor lead to much progress on non-income aspects of poverty. On both counts, human development programmes have a role to play.

It is worthwhile quoting here the final paragraph of *WDR 1980* which, like a bell, should have tolled throughout the decade of the 1980s for all those, including in the World Bank, who launched themselves on a development course so different from the one set out in the *Report*:

> Nothing can make widespread absolute poverty melt away overnight, and human development at best can do only part of the job. Without effective policies on other fronts, and without active and enlightened support from the rest of the world, progress will be agonizingly slow. But these other policies will not be sufficient. The most valuable resource any country has is its people, the means and the end of economic advance (p. 98).

### *B. The World Development Report 1990*

The 10-year period between the 1980 and 1990 *World Development Reports* was, as indicated earlier, a time of gross neglect of the social problem in general, and of poverty reduction in particular. It was as if the ground had opened up and swallowed all the reflection, the approaches, and even the vocabulary of the 1970s. There was preciously little discussion, let alone action, during the 1980s on the problems of land reform, employment creation, income distribution, poverty reduction, investment in education and health, meeting basic needs, etc. The bell tolled for adjustment policies, growth, privatization,

deregulation, and trade liberalization. Economic growth was once again seen as the panacea, despite all the available evidence such as that presented in *WDR 1980*.

In 1990, however, poverty was back on the World Bank agenda with *WDR 1990*. Conable just as McNamara ten years earlier, was in his final year as President of the Bank. In his Foreword, he says without flinching that, "the Report addresses the most pressing issue now facing the development community: how to reduce poverty" (World Bank, 1990, p. iii). He goes on to say that, for part of Latin America and most of Africa, the 1980s was a lost decade and a "review of development experience" shows that the most effective way of achieving rapid and politically sustainable improvements in the quality of life for the poor has been through a two-part strategy, namely (i) a pattern of growth that ensures productive use of the poor's most abundant asset - labour; and (ii) widespread provision to the poor of basic social services, especially primary education, primary health care, and family planning. There is, in fact, a third aspect of the proposed strategy consisting of "well-targeted" transfers to help those not able to benefit from these policies, and of "safety nets" to protect those who are exposed to "shocks".

While *WDR 1980* enumerated 800 million people living in absolute poverty (World Bank, 1980, p. 1), this number had risen to more than one billion at the end of the decade (World Bank, 1990, p. 1). *WDR 1990* cites its predecessor of 1980 only once, to say that it "argued that improvements in the health, education, and nutrition of the poor were important not only in their own right but also to promote growth in incomes, including the incomes of the poor" (p. 2). Although this is true, it hardly constitutes a complete summary of the proposals then made, as has been clearly shown above.

The two-part strategy is seen as more feasible than others, such as, for example, those involving land reform. After giving an approving nod to land redistribution in Japan and the Republic of Korea, *WDR 1990* concludes: "When it can be done, redistribution of land should be strongly supported. But the political obstacles to such reform are great. In most countries the two-part strategy which sees investment in education as the best way of augmenting the assets of the poor is more likely to succeed" (p. 3).

Let us now take a closer look at the two- (or three-) part strategy proposed. *WDR 1990* notes two "overwhelmingly important" determinants of poverty: access to income-earning opportunities and the capacity to respond to them. "When households have secure opportunities to use their labour to good purpose and household members are skilled, educated, and healthy, minimal standards of living are ensured and poverty is eliminated. When such opportunities are lacking and access to social services is limited, living standards are unacceptably low" (p. 38). Moreover, inability to cope with shocks can render relatively well-off households poor, and lead to starvation and death for those already impoverished. The *Report* cannot avoid noting that access to assets, including land, is important. It returns in more detail to the question of land reform and redistribution and concludes, tongue in cheek: "... tilting the redistribution of new investment in favour of the poor (as advocated in *Redistribution with Growth*, by Chenery and others), is likely to be more popular than reshuffling the stock of existing assets. If redistribution is impossible, the case for spending more on education and other forms of investment in human capital is all the stronger" (p. 53, see also Chenery et al., 1974).

The first part of the two- (or three-) pronged strategy, is concerned with the pattern of growth and the income of the poor. The *Report* puts forward four specific proposals to boost the use of labour. First, avoid excessive taxation of agriculture, provide strong support for rural infrastructure, and make technical innovations accessible to small farmers. Second, foster urban employment by avoiding severe distortions in product and factor markets and by providing urban infrastructure (p. 56). Third, increase the participation of the poor in growth by increasing access to land (again), and to credit, and improving access to infrastructure and technology. Fourth, resource-poor regions require policies that

facilitate out-migration, although additional investments will be necessary to meet "basic needs, maintain or increase yields, and preserve natural resources" (p. 73).

The second part of the strategy relates to social services for the poor, i.e. investment in human capital through improvements in education, health, and nutrition. These social services are considered an essential part of any long-term strategy for reducing poverty.

*WDR 1990* puts strong emphasis on this second part of the approach: "There is overwhelming evidence that human capital is one of the keys to reducing poverty ... improvements in health, education and nutrition reinforce each other" (p. 79). It asserts that more education gives the worker a wider range of self-employment options: "There can be little doubt that educating the children of the poor greatly improves their chances of escaping poverty" (p. 81). Just as the education of parents has a positive effect on child nutrition, better nutrition improves the child's capacity to learn, but there is little specific mention in *WDR 1990* of either health or nutrition, perhaps because "the effect of better health and nutrition on productivity is less well documented than the effect of education" (p. 81). A strong plea is made for family planning programmes.

The third part of the strategy concerns transfers and safety nets, because not all the poor will benefit from the above policies. *WDR 1990* looks at three clusters of policies, namely food pricing and distribution, public employment schemes, and social security. These measures are designed for two broad groups: those unable to participate in the growth process, and those who may be temporarily in danger when events take an unfavourable turn. According to the *Report*, the first group needs a system of transfers that will guarantee an adequate standard of living, whereas the second group is best served by a variety of safety nets.

*WDR 1990* contains an interesting chapter on adjustment policies during the 1980s (chapter 7: "The 1980s: shocks, responses and the poor"). It royally admits that "little attention was paid to the effects on the poor ... evidence of declines in incomes and cutbacks in social services began to mount ... it was UNICEF that first brought the issue into the centre of the debate on the design and effects of adjustment" (p. 103).[1]

By 1990, the World Bank had come to the conclusion that "efforts to restructure economies in the wake of a macroeconomic crisis are, by and large, consistent with a medium-term shift towards a pattern of growth and human capital formation that effectively reduces poverty" (p. 120).

The *Report* ends on an optimistic note. While the number of absolute poor increased by over 300 million during the 1980s, it is now claimed - but hardly substantiated - that this number may well decrease by nearly 400 million at the close of the century.

On completing this rapid review of two *World Development Reports* spanning the decade of the 1980s, it is somewhat surprising to note that we have come full circle and that, basically, the same message is conveyed in the two *Reports*. However, the 1990 message is more suave and even more careful about re-distribution policies, including land reform, than its 1980 counterpart. *WDR 1990* also puts even greater emphasis on human resources in general, and education in particular. One gets the impression that education is now viewed by the World Bank as the miracle remedy to poverty reduction. Despite the lip-service paid in *WDR 1990* to redistribution from growth à la Chenery (1974), this is not really detailed in concrete policy terms. More surprising again is the fact that the same remark can be made about employment creation policies, the very essence of the first part of the strategy. With more than 20 years of employment research and policies behind us, an evaluation of these efforts could usefully have been made in order to draw concrete policy lessons (Turnham, 1993). This was not done, and the policy recommendations remain as general as those in *WDR 1980*, and sometimes even more so. The prevailing impression is thus that the first part of the strategy is more about economic growth than about

employment creation as a means of reducing poverty. This is basically left to the social services arm, and more particularly to the miracle remedy, education. In this connection, it is also surprising that so little is said about either the quality of education or the structure of training and retraining.

On the whole, it can be said that the two *Reports* are on the same wavelength in their desire to design more employment and human-capital-intensive development strategies as the most effective means of reducing absolute poverty. It therefore remains a mystery why this well-known lesson was seemingly forgotten by the World Bank during the greater part of the 1980s, until a UNICEF report - as *WDR 1990* admits - brought the message home again at the end of the decade.

## II. Progress made over the last three years

The World Bank has produced several follow-up reports to further the implementation of the intentions laid down in *WDR 1990*. In 1991 a slim volume was published under the title *Assistance Strategies to Reduce Poverty* (World Bank, 1991). This was followed in 1992 by a robust volume, the *Poverty Reduction Handbook* (World Bank, 1992a), and, in April 1993, an important document entitled *Implementing the World Bank's Strategy to Reduce Poverty: Progress and Challenges* (World Bank, 1993) was issued, constituting a first evaluation of the progress made in implementing *WDR 1990*.

The 1991 document was intended to build upon the insights presented in *WDR 1990* for the Bank's policy and operational work. It states, somewhat strangely after the decade of the 1980s, that "it consolidates and describes the evolution of our longstanding approach" (World Bank 1991, p. 5). As a first step, the document proposed periodic assessments of poverty, the intention being to combine the analysis of macroeconomic and sectoral policy with the poverty profile, so that "the analyst is simultaneously alerted to the general impact of policy on the poor and reminded of the need to design programmes for the poor within a consistent, macroeconomic framework" (p. 19). The second step was to ensure that the volume and composition of World Bank assistance supports and complements the efforts of individual countries to reduce poverty. As general principles, it is stated that (i) the volume of lending should be linked to a country's effort to reduce poverty, and (ii) the composition of lending should support efforts to reduce poverty (pp. 20-21).

The third step was to assist countries developing an information and data base. Large-scale household surveys are important sources of information, but these are available in only a few countries in the South. The Bank thus proposed to undertake poverty profiles, cost-of-living indices, and design methods to measure access of the poor to basic health care and primary education. Finally, the document set out the actions required to implement the *WDR 1990* approach. In a strong statement, it is made clear that "the ultimate objective is to ensure that the assistance programmes undertaken by the Bank clearly help to reduce poverty" (p. 38). All assistance strategies must reflect, and be consistent with, an analysis of the main factors determining poverty. After decades of a "longstanding approach" to the reduction of poverty, it must be said in passing how surprising it is to read that the Bank "should prepare proposals to improve poverty-related data ... it is especially important to introduce a system rapidly, even if initially it is only a simple one, so that changes in the well-being of the poor arising from adjustment can be tracked" (pp. 39-40).

In its final paragraph, the document announced the preparation of a Poverty Handbook intended to provide examples of best-practice analysis and operational work, as well as an operational directive on poverty to provide practical guidelines to Bank staff.

### *A. The Poverty Reduction Handbook*

*Assistance Strategies to Reduce Poverty* provides a conceptual framework for moving from the *WDR 1990* emphasis on *country* investments - policies, public expenditures, and institutions - to *Bank* instruments, such as economic and sector work, the policy dialogue, lending, technical assistance and donor coordination.

The *Poverty Reduction Handbook* (hereafter referred to as the *Handbook*) was intended to go one step further. It surveys operational approaches to poverty reduction and provides a framework for (i) analyzing poverty and preparing country poverty assessments, (ii) designing assistance strategies for individual countries to support their efforts to reduce poverty, and (iii) measuring and monitoring progress. Basically, the *Handbook* provides task managers in the World Bank with guidance to "good-practice" operational approaches, in a whole spectrum of fields. Thus, it recommends that policy, public expenditure, and institutions be analysed from a poverty reduction perspective, focusing on (i) the efficiency of incentives policies; (ii) the cost-effectiveness of public expenditures, in particular in developing the human capital of the poor; and (iii) the cost-effectiveness of the safety net. Further, it recommends the financing of programmes and projects that support and enhance country efforts to reduce poverty; the focusing of sector work in order to develop strategies that promote poverty reduction and "pre-identify" new projects that could simultaneously yield high returns and benefit the poor, with particular attention to projects that would not be undertaken - or would be done less well, with a reduced poverty focus - without the Bank, or which pioneer approaches that can be replicated in other public investments.

The *Handbook* also recommends - with illustrations - addressing implementation, monitoring, and evaluation at the project- or programme-design stage; establishing a benchmark data base for determining, during implementation, whether the project or programme remains on track; and providing sufficient flexibility in design to allow adaptation of the project or programme as warranted.

It pleads in favour of a participatory approach, involving poor client groups in project and programme identification, design, implementation, and monitoring and evaluation. It favours a flexible approach to permit constant improvement of projects and programmes through sensitive and timely learning of changing conditions, experience and impact, followed by timely action.

Finally, the *Handbook* prescribes (i) the monitoring of both country performance on poverty reduction, including progress on social and economic indicators, and the Bank's contribution through policy dialogue and lending; (ii) coordination with other agencies in order to share experiences and strengthen the effectiveness of development assistance for poverty reduction; and (iii) assistance to countries in improving data gathering, by focusing on user-driven systems and arranging, where needed, financial support and technical assistance.

### *B. Implementing the strategy*

The two World Bank documents referred to above represent an ambitious programme. They set out to re-orientate all of the Bank's work towards the prime goal of economic development, namely the reduction of absolute poverty, in order for all human beings to achieve a level of income below which no decent existence is possible.

According to the instructions contained in both *Assistance Strategies* and the *Handbook*, all projects and programmes which the Bank is to undertake must be vetted with respect to their impact on poverty; national policies to reduce poverty must be stimulated and assisted; and the information and data base concerning the poor, their characteristics, and how they can best be reached, must be generalised and improved.

The Bank, to its credit, was itself the first to bring out a progress report in early 1993 (World Bank, 1993, hereafter referred to as the *Progress Report*) which set out to measure the progress

made so far in the implementation of the strategy presented in *WDR 1990*, in *Assistance Strategies* and in the *Handbook*. In his Foreword, Lewis T. Preston asserts that "the report shows what best practice in work on poverty can accomplish" (p. iii). Let us take a closer look at what this means.

The *Progress Report* states that developing countries "have made substantial progress in reducing poverty over the past three decades, although recently there has been some loss of momentum. The key challenge is thus to resume the more rapid rate of poverty reduction of earlier years" (p. ix). The Bank therefore has its work on poverty cut out for itself! The *Progress Report* claims (after only a little more than two years), that, "progress in implementing the poverty reduction strategy is clearly visible in the composition of Bank lending. While the volume of lending for agriculture has remained constant in nominal terms, lending for rural infrastructure (for example, roads, village infrastructure, and electrification) has expanded. Meanwhile, investment lending for human resources development has increased almost fivefold since the early 1980s; it increased from 5 per cent of total Bank lending in fiscal 1981-1983, to 14 per cent in fiscal 1990-1992. In particular, lending is now concentrating on the development and extension of basic social services, such as primary health care and primary education, with special emphasis on maternal and child health, and on improving educational opportunities for girls" (p. xi).

It must be noted that the only dates given here refer to lending for investments in human resources, and that the period under consideration is situated before 1990-1992, when the Bank announced its return to the poverty reduction objective. Apparently, at least for human resources, the Bank did not need to be extolled! It is also interesting to note that Bank lending for agriculture has declined in real terms.

The Bank has launched a Programme of Targeted Interventions (PTI) which consists of investment operations that include a specific mechanism for reaching the poor and/or in which the participation of the poor significantly exceeds the proportion of this group in the population as a whole. In fiscal 1992, the PTI included 51 projects in a wide range of sectors, the total value of which amounted to about 14 per cent of new lending. This is clearly a far cry from the guidelines laid down in the target documents, namely *WDR 1990, Assistance Strategies* and the *Handbook*.

Bank-supported research on poverty has been increasing. The proportion of resources (from the different research funds) devoted to poverty reduction and human resources development increased from 25 per cent in fiscal 1990 to 30 per cent in fiscal 1992 (p. xii). The *Progress Report* recognizes that a lot remains to be done. For the Bank's future directions, it makes a distinction between country issues and World Bank issues. In the framework of the country issues, it looks at the two-part strategy. Intriguingly, the labour-intensive pattern of growth set out in *WDR 1990* seems to have been replaced by a growth strategy *tout court*: "The challenge for these countries is to restore the climate for sustainable growth and human resources development, by putting in place and maintaining an appropriate macroeconomic framework, and by restoring spending on basic social services. To minimize the potentially adverse impact that the introduction of stabilization policies may have on the poor, in the short term, safety nets can be introduced within the context of the overall macroeconomic framework" (p. xii). This appears remarkably similar to the theme of the 1980s: growth, but this time without neglecting the social sectors such as education and health, and with safety nets where necessary. The second and third parts of the strategy are safeguarded, but the pattern of growth seems to have disappeared.

In the framework of World Bank issues, the *Progress Report* makes a plea for widening the coverage of poverty assessments (better information and data base); generating analysis in poverty assessments (more research and analysis); and evaluating on-the-ground impact (pp. xiii-xiv).

The *Progress Report* also mentions the desire for a participatory approach, and for the

strengthening of partnerships. All this amounts, of course, to a set of commendable objectives, mainly in the research, analytical and data-collection fields. But the question must be asked: "Where is the 'beef'?". Although the World Bank is a *development* bank, it is also a *bank* that lends money. And more, indeed practically all of its money, if the target documents are taken as a guide, must go into more employment-intensive development projects and programmes, into human resources investments, into other social sectors, and into the creation of safety nets "where necessary". The World Bank appears to be long on setting out its research and laudable objectives, but short on detailed explanations as to where exactly its money goes. More than one observer has been struck by the strange and embarrassed silence that falls when the question is posed to one or another Bank official: "The sincerity of your intentions and the excellence of your research is not in doubt, but can you show me the figures?"! After all, any Government, institution or individual must be judged not on the priorities accorded to the objectives to which lip-service is paid, but on where the resources actually go. Let us look at the *Progress Report* in somewhat more detail, in order to see whether some light can be shed on this issue.

Agriculture and rural development, water supply and sanitation, and human resources development are the sectors on which the Bank has concentrated its direct efforts to reduce poverty. During the 1970s, funding for agriculture and rural development constituted the largest of these three sectors. But, as already mentioned, while lending in human resources development increased, the volume of lending to agriculture levelled off during the 1980s (pp. 15-16).

However, the Bank claims that, within agriculture, lending has expanded to help develop rural infrastructure (roads, village infrastructure, and electrification) which now accounts for more than one-quarter of total lending for the rural sectors. Lending for water supply and sanitation has remained roughly constant at around 5 per cent of Bank lending in the 1980s and 1990s.

Table 1 is interesting in more than one respect. First of all, it shows that, overall, lending with a social sector and poverty focus has gone down from 37 to 36 per cent of total Bank lending during the past 12 years. Secondly, it indicates clearly the social and poverty disaster of the 1980s, with lending down to 29 per cent of the total at the end of the decade. Thirdly, it can be seen that lending for agriculture and the rural sector which, at the end of the McNamara period stood at an all time high of 27 per cent of total Bank lending, has been decreasing ever since - swiftly during the 1980s and then at a slower rate. Fourthly, the swing of the pendulum in favour of social and poverty lending since the late 1980s is due solely to an explosion of lending for human resources development which increased from 6 to 14 per cent - from $660 million to $3,000 million (in current dollars).

For the World Bank, human resources development includes education, population, health and nutrition. Education lending has gone up from $600 million to $1,900 million; but population, health and nutrition increased from $60 million to $1,150 million!

The policy conclusions that can be drawn from this table are clear: (i) no overall increase in poverty-focused lending can be observed since 1980; (ii) there has been an increase in education lending, but more particularly in lending for population, health and nutrition since the second half of the 1980s.

The Bank claims that "a review of the Bank's adjustment lending shows that it has broadly supported the kind of reforms that over the medium term are likely to restore growth and reduce poverty" (p. 19). But the only illustration given, always the same, is Indonesia. Moreover, a few lines further on, and somewhat paradoxically, the *Progress Report* states: "Since the late 1980s the share of adjustment loans that generally consider social issues to one degree or another has increased sharply from less than 5 per cent of all adjustment loans during fiscal 1984-1986 to more than 50 per cent during fiscal 1990-1992" (p. 19). The conclusion must be that there is still a long way to go.

*Table 1*

**ANNUAL LENDING TO POVERTY-FOCUSED SECTORS, 1981-1992**

| | *Per cent share in total IBRD lending* | | | *Millions of dollars* | |
|---|---|---|---|---|---|
| | *1981-1983* | *1987-1989* | *1990-1992* | *1981-1983* | *1990-1992* |
| Human resources | 5 | 6 | 14 | 660 | 3000 |
| Agriculture and rural | 27 | 19 | 17 | 3500 | 3700 |
| Water supply and sanitation | 5 | 4 | 5 | 600 | 1000 |
| Total | 37 | 29 | 36 | 4760 | 7700 |

***Source:*** World Bank (1993).

During the second half of the 1980s, adjustment lending became more poverty-focused in three areas. First, more attention was given to safety nets and to restructuring public spending. The most common safety-net interventions have been labour-intensive public works, nutrition programmes, targeted food subsidies, and the provision of family benefits and pensions, but normally these interventions are not (well) integrated with the overall economic development strategy. Second, some loans are based on an assessment of how reforms will affect the poor both in the transition period and in the longer term. This comes close to an integrated approach, which is as it should be. Third, a number of adjustment loans include conditions for the release of tranches that relate to a country's efforts to reduce poverty. The share of loans that include such social-sector conditionality increased from 5 per cent of all adjustment loans in 1984-1986 to close to 30 per cent in 1990-1992 (p. 20).

One lesson the World Bank has still to learn is how to identify the most efficient mechanism for directing the benefits of government spending to the poor. Here again the Bank seems to see investment in human capital as the panacea for poverty reduction: "Targeting broadly by spending on public services that tend to benefit the poor disproportionately, such as education and health, is often an effective way to deliver certain services to the poor" (p. 33).

Towards the end of the *Progress Report* it is maintained that the Bank "has made wide-ranging efforts to reflect the *WDR 1990* approach in the design and implementation of its country assistance strategies" (p. 36). This assertion is followed by a plea in favour of more poverty assessments, cost-effective approaches, dissemination of lessons learned, research into new topics, improving data, etc., i.e. for more and better data bases and research (pp. 37-39).

Our conclusion is that the report *Implementing the World Bank's Strategy to Reduce Poverty: Progress and Challenges*, published in April 1993, is stronger on assertions and on analytical and research needs than on showing that the volume of lending (the "beef") has swung heavily towards poverty-reduction programmes. This is not the case. The percentage of poverty-oriented lending is less today than it was at the end of the McNamara period. The only recent upturn is in the volume of educational lending, and much more spectacularly of lending for population, health and nutrition. This is not unimportant, but in the best of cases it will only be able to make a dent in poverty in the longer run.

### *C. The World Bank Annual Report 1992*

The above conclusion is a matter of some importance, and it is therefore essential to verify this against the latest evidence available. *WDR 1990* identified a path of poverty reduction that could reduce the number of poor in the world

by 400 million between 1985 and the year 2000. However, the World Bank *Annual Report 1992* concludes that "such a target appears no longer feasible, partly as a result of the severity of the current recession and the disappointing progress in the 1985-1990 period, and that, in fact, the number of absolute poor in the world at the turn of the century will probably be higher than in 1985" (World Bank, 1992b, p. 46). This grave warning, however, is followed by very much the same story contained in the *Progress Report* (pp. 46-55), with, once again, lending for human resources development as the showcase. In this connection, the *Annual Report 1992* observes that (i) by 1994 the volume of education lending and lending for population, health and nutrition will be roughly equal; (ii) social sector projects are emerging, mainly designed to protect the poor during periods of economic adjustment; and (iii) more than half of all Bank lending - by constant dollar volume - for human resources development has taken place since 1987, and about two-thirds of all lending for population, health and nutrition has taken place in that same period.

The *Annual Report* concludes that "information on project outcomes is limited and much of what is known relates to a portfolio that was designed and implemented under conditions substantially different from those that have prevailed in the past five years" (p. 54). This statement is somewhat at odds with the fact that the World Bank made its first education loan in 1959 (Tunisia), i.e. more than 30 years ago, and that it carried out rate-of-return analysis on education for this entire period and more intensively and generally over the last 20 years.[2]

The *Annual Report* confirms, in consequence, that two of the highest resource priorities relate to poverty reduction and human-resource development: "Much of the Bank's research effort is devoted to investigating how to protect the poorest and most vulnerable groups during periods of economic stagnation and instability" (World Bank, 1992b, p. 93). One gets the definite impression that the bulk of poverty research and projects is focused, rather belatedly, on short-run adjustment pro- grammes, and that for the social and poverty questions in a longer run development perspective the Bank relies on human development research and projects.

The *Annual Report 1992* has a section containing summaries of projects approved both for the IBRD and IDA (pp. 157-175). These are very short descriptions of the loan projects and much caution must be exercised in drawing hard and fast conclusions. But they do contain interesting, and for our purpose, relevant information. It must be recalled that the "implementation documents" (the *Handbook* and *Assistance Strategies*) are very explicit in their demands that all future projects be vetted for their social and anti-poverty content. However, this demand is not reflected in the projects approved during fiscal 1992, at least not in the summaries. For example, of the 54 projects approved in agriculture and rural development, only about 25 per cent have something specific to say about poverty. There are, in fact, slightly more projects explicitly focused on the environment and natural-resource management than on poverty. There is even one project in Papua New Guinea to protect an "endangered butterfly species and its associated ecosystem" (p. 160). Far be it from us to criticize environmental considerations, but nowhere is the link with an anti-poverty focus made explicit.

Of the 11 approved projects for development finance companies, all mention economic growth, but only one ($2.9 million to Guinea-Bissau!) has anything to say on social issues, and none on poverty.

In the energy sector 28 projects were approved in 1992. Only one mentions that "the incidence of poverty will be reduced" (in Hainan, one of China's poorest provinces) (p. 164). Out of five industry projects none mentions anything either closely or remotely associated with anti-poverty objectives. Rather, they are all concerned with market orientation, economic growth, privatization, etc.

We shall pass over the so-called non-projects (several mention "employment"), public sector management, telecommunications and transportation. We shall also pass over the

significant fact that only one small-scale enterprise project was approved in 1992 (in Poland!) (p. 170) and that of the 17 technical assistance projects, social policies or poverty objectives cannot be detected. Let us pause instead at the urban development projects, of which 15 were approved during fiscal 1992.

The interesting point to note here is that the documents reviewed earlier have preciously little to say about urban development, but a good deal about agriculture and rural, as well as human resources, development. Indeed, urban development does not even figure in the "poverty-focused sectors" of the Bank (table 1). However, in studying the 15 projects, it transpires that more than half contain interesting proposals concerning employment, income levels of the urban poor, the promotion of small and medium-sized enterprises, labour-intensive technologies, low-cost housing, the lower-income end of the housing market, reducing the "historical disparity between the North and the South" (of Uganda), low-income inhabitants of city slums, etc. (pp. 173-174). This part of the Bank's activity is easily the most social and poverty intensive of all those reviewed thus far.

In education, 26 projects were approved in 1992. A majority of them focus on the quality of primary and basic education. Very few concentrate on scientific and technical education and, as far as we have been able to see, none focus on the creation of Centres of Excellence at the highest level of research and education (pp. 162-164). Significantly, the Republic of Korea is one of the few countries to have taken out a loan to improve the quality of basic science education, and another in order to upgrade the "skill training provided in selected vocational high schools" (p. 163). The only other countries to have opted for a loan in science programmes are Mexico and the Philippines. The latter is the only country to borrow Bank money to "improve employment and training policies, strengthen employment services, improve non-formal rural basic training, and increase private sector involvement in training" (p. 164).

The emphasis on the quality of education is welcome, because in so many countries (including in the OECD area) the fixation on enrolments and quantity has resulted in a disquieting lowering of quality. Emphasis on primary and basic education is a direct result of the outcome of rate-of-return analyses of investments in education which have shown, over and over again, that the rates of return on basic education are higher than those on secondary and higher education. But here a point must be made, one that we feel is important. Social reform and socio-economic policies go beyond poverty-reduction strategies. All countries must become and/or remain competitive on the global markets. They must have robust outward-oriented and competitive economic activities based on innovation, high tech and science. Centres of excellence in science and technology are thus of the essence, as is vocational training and retraining. Again somewhat paradoxically, the Bank is going too much to one extreme, at least as far as the 1992 evidence shows. We say "paradoxically" because it confirms that the Bank relies too much on education for poverty reduction and tends to neglect the other purposes that education must serve. Striking the right balance is crucial in this instance.

In population, health and nutrition, the Bank approved 16 projects in fiscal 1992 (pp. 168-169). Less than half of these refer explicitly to poor rural and urban communities, safety nets, reduction of fertility, access to basic health and labour-intensive works.

Finally, let us look at the cumulative lending operations of IBRD and IDA by major category as of 30 June 1992 (p. 194). Of the grand total of outstanding loans of $218,000 million, $10,000 million, or less than five per cent, went to urban development (the most social-and-poverty intensive sector in 1992); $40,500 million, or less than 20 per cent, went to agriculture and rural development, an important proportion of which related to growth rather than to employment and income opportunities for the poor; $47,200 million, or more than 20 per cent, went to energy;

$21,400 million, or 10 per cent, to development finance companies; and $16,000 million, or more than 7 per cent, to industry. Transportation received $31,000 million, or close to 15 per cent of the grand total. The cumulative total for education is a mere $9,500 million, or less than 5 per cent, and for population, health and nutrition only $2,650 million, or just over one per cent!

In conclusion, when one looks at where the money goes, it is clear that the World Bank is as of yet nowhere near meeting the social and poverty targets it has set for itself since *WDR 1990*. It has also an erroneous classification of "poverty-focused sectors", excluding the most poverty-intensive of all, namely urban development. It is, moreover, neglecting the pattern of development to the benefit of economic growth *tout court*, while having fallen back in agriculture and rural development, and paradoxically putting too much emphasis on basic education. Land reform projects are hard to find, and income distribution is scarcely mentioned. All in all, although sincere intentions are evident, concrete action is lagging very much behind.

## III. A critical review

The progress achieved since *WDR 1990* has not been as impressive as the *Progress Report* (World Bank, 1993) would have us believe. That much is clear from the discussion contained in the previous section.

The emphasis is on words and research rather than on deeds and money. But even in the area of research, it is astounding to note that the data base is apparently still so weak. It is hard to understand why, after all these years, there is still such a paucity of data on the poverty problem. Moreover, much of the available data collected by the Bank (*Poverty Profiles*, for instance) remains confidential, even for colleagues and professionals from sister institutions. This borders on the absurd.

One of our greatest preoccupations is the pattern of growth. *WDR 1990* and the implementation documents all emphasize the desirability of a two-part strategy, of which the very important first part is supposed to be a more labour- or employment-intensive economic and social growth path. In this context, it will be recalled that earlier in this paper we referred to the East-Asian development model, and the generally accepted assertion that it was the employment orientation of that strategy which led to full employment within an acceptable transition period. However, from the *Progress Report*, as well as from what can be distilled from the actual loan descriptions, the impression emerges that this first part of the two-pronged strategy has not been actively implemented. The emphasis continues to be on growth rather than on the pattern of growth.

This judgement is based on the fact that there is no implementation evidence concerning projects related to employment-intensive technologies, to small and medium-sized enterprises (one project approved in 1992!), implications of income distribution and trade on employment creation, labour market policies, etc. It is, after all, the creation of productive employment and income-earning opportunities - particularly in the hitherto low productivity sectors of the economy - that is the most effective and growth-stimulating way to tackle the poverty issue in any country. The only sector of the World Bank where this is discussed to some extent is in urban development, a sector that otherwise is not considered "poverty-focused". On the other hand, we have noted several times in this paper that Bank lending to agriculture and rural development has decreased considerably, both in relative and real terms, which is regrettable because, obviously, this sector is crucial for poverty reduction. In consequence, and despite what is written in *WDR 1990* and the implementation reports, the actions of the Bank would seem to be based on the assumption that economic growth - any type and pattern of growth - is good for social development and poverty reduction.

This is an old assumption and has triggered an out-dated discussion. Was it not towards the end

of the 1960s when we noted that high growth (five per cent per annum) could result in more poverty rather than less, in more unequal income distribution and a bigger employment problem? And was it not subsequently concluded that in the long run - over several generations - economic growth could make a dent in all these factors, but that clearly the transition period was unacceptably long? And that therefore ways must be found to shorten that transition period, which brings us back to the question of the pattern of growth? The World Bank has understood this message on paper - hence the two-part strategy. But this seems to have been forgotten when it comes to actual financing.

Another critical issue relates to the "third part" of the strategy proposed in *WDR 1990*, namely the setting up of safety nets for the most vulnerable groups. No trace is to be found of this element in the approved projects for fiscal 1992. The *Progress Report* mentions four public-works projects in 1990-1992; an unspecified number of "labour-intensive works during natural disasters"; and some other more or less clear examples (p. 20, box 8). Once again, it would seem that the Bank is not only timid when it comes to the crucial question of the pattern of growth, but equally modest in taking into its care the victims of wrong patterns of development.

We have already commented on the human resources development "explosion" of recent years. The actual strategy of the Bank, as opposed to its declared intentions, seems to be economic growth, plus basic education, plus health and population equals improved quality of life and less poverty. This is exactly equivalent to the strategies followed in the 1960s and early 1970s. They work if you live long enough to benefit from them!

## IV. An integrated approach towards socio-economic reform

There are several lacunae in the World Bank approach: there is no sense of urgency, no feeling of the necessity for an integrated economic and social development strategy, and no distinction between emphasizing social sectors and poverty on the one hand, and social reform with clear priorities on the other.

The renewed interest in the social sector and poverty is largely the result of the growing recognition that there is a social time-bomb ticking under the financial and economic policies of the 1980s, which in quite a few cases have led to economic recovery. The social price being paid for these policies and recovery is leading to social unrest which can only be dealt with through social reform. Such unrest is caused by lack of remunerative employment opportunities, bad living conditions in the cities and the rural areas, and lack of perspective and hope.

Any socio-economic reform package must therefore contain the following priorities:

*(1)* *Urban policy.* Few countries have an urban policy on any comprehensive scale. Social unrest is in no small measure due to the very poor living conditions in the cities. The city is often the most extreme illustration of the faulty development of countries and regions. The World Bank has recently become very active in urban development and sensitive to the social and poverty questions raised here. This work must be further stimulated and integrated into the overall approach to social reform and poverty reduction.

*(2)* *Employment policies.* These must be economy-wide in scope. The full and productive utilization of the entire labour force is a precondition for achieving high and sustained rates of economic growth. Economy-wide employment-maximizing efforts are not, and should not, be quick-fix solutions to social and poverty problems, but rather should be analysed so that they provide the underlying economic basis for productivity improvement, income growth and asset accumulation. Land reform must be put on the agenda again, because it will boost the income of small farmers;

productivity within the traditional rural and informal urban sectors must be increased in order to avoid the spread of low productivity and low-wage employment. This will require an emphasis on appropriate technology within these sectors, and on linkages between these sectors and the modern sector through such devices as subcontracting. The functioning of labour markets must be improved, and youth employment in the transitional adolescent years should be given special attention. The World Bank is aware of the importance of the creation of employment and, more generally, of income-earning opportunities, but there is no clear idea of how much money it spends on promoting employment and labour market projects in the framework of a more labour-intensive development strategy.

(3) *Investment in human resources.* Special attention must be given to the quality of education, which means, among other things, that the quality and motivation of teaching staff must be improved. This, in turn, implies looking at monetary and non-monetary incentives and disincentives. Vocational, technical and science education at all levels, as well as training and retraining - particularly whenever people are between school and work or between jobs - must also be given pride of place. In the health sector, a good balance must be maintained between hospitals and preventive health care, and the allocation of resources must switch to the latter. We have the impression that the Bank is covering these areas, with the exception of the emphasis on vocational, technical and science education, and to a lesser extent on training and retraining.

(4) *Institutional change.* A socio-economic reform policy along the above lines would remain an empty gesture as long as the archaic administrative and budgetary structures of social, educational, labour and health departments in many countries remain in place. Without the streamlining and modernisation of those structures, the efficiency and success of any policy reform must remain in doubt. In a real sense, therefore, institutional change is the prerequisite of all other changes. Although we are sure that the World Bank agrees with this, there is preciously little to show for it in concrete loan projects.

(5) *Social security.* A modern society needs to have mechanisms and safety nets in place to deal with the old, the sick, the disabled, the unemployed, and the victims of natural disasters. In the regions which have social security systems (Latin America, for instance), they often look good on paper, but a closer inspection shows serious inequities (due to changing levels of inflation), severe financial problems, and that the benefits are not always enforced. Another objective of social policy reform must therefore be to reform social-security systems in order to increase their coverage and make them more equitable and efficient, both in terms of their administration and enforcement. The World Bank hardly mentions this dimension.

The complementarities between economic and social reforms will now be clear and, in fact, the distinction between economic and social policies practically disappears given the intimate relationship between the two. Productive employment creation is both an economic and a social objective. In any social reform, employment creation must be high on the list of priorities. At the same time, it is a top economic priority because the full utilization of the country's labour force will boost economic growth and development.

The same is true for policy action to increase output and productivity in the urban informal and rural traditional sectors. The complementarity between the social objective of creating more and better income-earning opportunities and the economic objective of achieving more balanced and widespread economic growth is obvious.

Moreover, in the global markets that dominate the world economy of the 1990s, all countries must put more emphasis on innovation, science and technology. This implies by definition more emphasis on human capital, i.e. on education and on the quality of the human factor in general. But it also implies that priority must not only go to basic education. Indeed, if innovation, science and technology are to be put at the heart of economic growth ("the goose that lays the golden eggs"), then the creation of Centres of Excellence in education and research becomes equally important.

Finally, the way people live in urban and rural centres - i.e. the quality of life - has very important implications for the productivity of the labour force. Here again, the relationship between quantity and quality, between economic and social reform stands out. An integrated set of economic and social policies, as illustrated by the above examples, will produce both more equity and efficiency, will improve the competitive edge of countries, and will, therefore, provide the necessary balance to the financial and economic reforms of the 1980s.

The World Bank must be urged to prepare social-reform packages with clear priorities complementary to the economic and financial reforms it helped introduce in the 1980s. As things are now, the only priority that really stands out in the World Bank approach is education in general, and primary and basic education in particular. That is hardly a social reform policy or an integrated economic and social development approach.

## V. Concluding remarks

The World Bank has successfully integrated poverty as a first-order priority in its reports, but not in its actual lending practice. As for the social sector in general, the Bank is deficient - both in practice and in theory - with respect to defining this sector and to coming up with an integrated set of socio-economic priorities. It follows that the modalities of actual practice do not accord fully with the stated poverty objectives. The Bank only very partially carries forward the - admittedly very ambitious - objectives as stated in its own *Poverty Reduction Handbook* and in the other documents reviewed in this paper.

Analogous remarks can be made about adjustment lending. Human resources lending has received a big boost during the last three to five years. Basic education is viewed as a panacea for poverty reduction. Population, health and nutrition lending is also increasing very rapidly. But relatively little is happening on the crucial front of the pattern of growth.

To sum up in one remark: the improvements within the past three years have been in urban-development lending (outside the Bank's definition of "poverty-focused" sectors) and in the quantity of human resources development lending. Progress has also been made in the Bank's thinking in as far as it has rejoined the best of its ideas of the 1970s, which should never have been abandoned. But all the evidence and the embarrassed silences indicate a considerable gap to date between thinking and theory on the one hand, and practice on the other.

## *Notes*

1 The reference to UNICEF relates to Cornia et al. (1987), which was published more than five years after adjustment policies had started.

2 See the reports and books by George Psacharopoulos, published by the World Bank.

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# STRUCTURAL ADJUSTMENT POLICIES AND ECONOMIC PERFORMANCE OF AFRICAN COUNTRIES

**Nguyuru H.I. Lipumba***

***Abstract***

*This paper reviews the IMF study "Economic Adjustment in Low-Income Countries: Experience Under the Enhanced Structural Adjustment Facility" and the World Bank report "Adjustment in Africa: Reforms, Results and the Road Ahead". It also examines structural adjustment policies in general and discusses the role of the Fund and the Bank in the design and implementation of policy reforms in Africa.*

*The main conclusion is that stabilization and adjustment policies have been oversold as to their effectiveness in initiating sustained growth. Structural adjustment programmes have lacked coherence between short- to medium-term stabilization objectives and the long-term development objective, which involves institution building and enhancing abilities to learn, adopt new technologies and manage complex organizations. The lack of success of economic reforms in Africa is also partly explained by lack of domestic ownership of the programmes.*

*Better policy-making and implementation of reforms is a task for the African Governments themselves. The efficiency of public administration has to be raised and African government bureaucracies have to be restructured. The main challenge facing African Governments is to reform their tax systems, to improve tax administration and to set growth-oriented priorities in government spending. The international community can support such efforts by across-the-board debt cancellation and additional development assistance.*

## Introduction

The 1980s have been characterized as a lost decade for Africa. Real per capita incomes were lower at the end of the decade than at the beginning throughout sub-Saharan Africa with the exception of a few countries such as Botswana and Mauritius. During the second half of the 1980s, almost all sub-Saharan African countries adopted stabilization and structural adjustment programmes designed by the IMF and the World Bank. The objective of these policies was to stabilize the economy by reducing the budget deficit and controlling the growth of credit, and to "get the prices right" through massive currency devaluation and liberalization of trade and agricultural markets.

In the financial sector, reforms were aimed at increasing nominal interest rates to make real interest rates positive and to restructure the financial system to promote competition while

* This paper has benefited from the author's earlier policy paper published by ODC, *Africa Beyond Adjustment*.

maintaining the solvency of financial institutions. Governments were also urged to step aside from commercial activities by privatizing public enterprises and imposing hard budget constraints on those enterprises remaining within the public sector.

After a decade of structural adjustment, the sustained growth that will alleviate poverty remains elusive and the number of the poor is increasing. Many African countries are suffering from a serious case of adjustment fatigue as large currency devaluations have not led to an improvement in the balance of payments, and liberalization has neither increased output nor created more employment opportunities. Moreover, Governments must manage not only economic adjustment policies but also political reforms, introducing multiparty political systems in which good economics is not necessarily good politics, at least in the short run.

In September 1993, the IMF published a study entitled "Economic Adjustment in Low-Income Countries: Experience Under the Enhanced Structural Adjustment Facility" (IMF, 1993). The paper analyzes the impact of adjustment policies on 19 low-income countries that used their access to the Enhanced Structural Adjustment Facility (ESAF) as of mid-1992. Of the 19 countries all but four are African.[1] A World Bank report of early 1994, entitled "Adjustment in Africa: Reforms, Results and the Road Ahead" (World Bank, 1994), assesses the results to date of economic reforms and structural adjustment policies undertaken by 29 African countries.[2] Both studies arrive at positive conclusions: adjustment policies are working. However, the two studies differ in methodology. The World Bank is analytically more sophisticated and comprehensive, while the IMF uses the "before and after" method comparing performance before and after adopting SAF and ESAF programmes.

This paper critically reviews the two studies and examines structural adjustment policies in general and discusses the role of the IMF and the World Bank in the design and implementation of policy reforms in African countries. In chapter I a critical review of the IMF occasional paper is undertaken. Chapter II gives a comprehensive review of the World Bank report, outlining its main strengths and shortcomings. Chapter III compares the findings of the two studies. Chapter IV discusses structural adjustment programmes more generally, reviewing appropriate design and sequencing of adjustment policies and the need for them to be part of an overall long-term development strategy "owned" by the respective African countries.

The main conclusion of this study is that stabilization and adjustment policies have been oversold as to their effectiveness in initiating sustained growth. Structural adjustment programmes lack coherent linkage between the short- to medium-term objective of attaining balance of payments equilibrium and attaining allocative efficiency and the long-term objective of development which involves building responsive institutions for appropriate governance and enhancing the ability of individuals to be more productive, to learn and adopt new technologies, and to manage complex organizations.

One of the lingering tragedies of the economic crisis of the 1980s is the further erosion of the historically low capabilities of African Governments to design and implement workable development policies. Following the collapse of African bureaucracies in the wake of budget crises in the early 1980s, the IMF and the World Bank took over the design of stabilization and adjustment policies that were neither understood nor supported by most of those who are expected to implement them. In the studies analyzed in this paper, the IMF and the World Bank seem to be desperately in search of structural adjustment success stories in Africa that will justify the policies. Unfortunately, there are no such success stories. The development crisis in Africa is first and foremost a crisis of the African States, and through their stabilization and adjustment policies, the IMF and the World Bank have overloaded the weak institutional systems in Africa with too many reforms in an inappropriate sequence. This has further weakened African States. The conditionalities imposed by the IMF and the World Bank have been accepted not as a

result of domestic consensus on adjustment policies but because of a need for access to financial resources of multilateral and bilateral donors. Policies have been accepted under duress without conviction as to their relevance. As a result, effective implementation has been lacking.

## I. A review of "Economic Adjustment in Low-Income Countries"

The typical 12-month IMF stabilization programmes have been criticized as unsuitable for resolving the protracted balance-of-payments problems facing many developing countries because they were short-term in nature and concentrated on reducing aggregate demand rather than removing supply constraints (see, for example, Dell, 1982, and Killick, 1984). A number of countries, such as Liberia, Sudan, Zaïre and Zambia that had signed stand-by arrangements with the IMF in the late 1970s and early 1980s, subsequently started accumulating payment arrears in servicing their outstanding debts with the IMF.

The World Bank introduced structural adjustment lending in the early 1980s which "trespassed" upon IMF turf because it provided, among other things, balance-of-payments support for macroeconomic reform. In response to widespread criticism of the ineffectiveness or harm done by stand-by arrangements to poor countries, the institutional competition from the World Bank, and the insolvency of most low-income countries, particularly in Africa, the IMF created, in 1986, a Structural Adjustment Facility (SAF) which could only be accessed by low-income countries.[3] SAF was financed by reflows of Trust Fund money that originated from the profits of the sale of part of the gold owned by the IMF. Eligible countries could initially cumulatively borrow over three years up to 70 per cent of their quota, which was later reduced to 50 per cent. The loans were concessional, with an interest rate of 0.5 per cent (compared to commercial rates for other facilities), and were repayable over up to 10 years with a grace period of five and a half years. The conditionalities imposed by the IMF on borrowing countries for access to SAF resources were relatively soft.

In 1987, the IMF created the Enhanced Structural Adjustment Facility (ESAF) to support "especially vigorous" reform and adjustment programmes in low-income countries. Concessional interest rates, repayment schedules and grace periods applied to credits obtained through the ESAF window were similar to those of the SAF window. Under ESAF, a country could access up to 110 per cent of its quota but in exceptional circumstances a country could obtain credit of up to 255 per cent of its quota over a three-year period. Countries accessing ESAF were supposed to have a comprehensive and vigorous reform programme. The IMF imposed stringent conditions and expected major reforms, such as exchange rate adjustment and liberalization of the payments system to be implemented at early stages of the programme.

The IMF study reviews the experience of countries that entered ESAF arrangements between 1988 and June 1992. The main objective of the study was summarized as follows: "Policy programmes supported by ESAF resources are to aim at a substantial move during the three year program period, toward an overall external position and structure of the balance of payments consistent with orderly relations with creditors (including IMF) and a trade and payment system free of restrictions" (IMF, 1993, pp. 1-2). Three specific macroeconomic objectives are identified: first, achieving "sustained economic growth at or near potential output and, indeed, to raise potential over time in a non-inflationary manner"; second, to attain a sustainable balance-of-payments position by the end of the programme, that is, "an external current account deficit that could be financed by normal and sustainable capital inflows (including aid)"; and third, "to identify and prioritize structural problems" in cooperation with the World Bank and the Government.

The paper argues that the initial setting of countries that accessed ESAF resources was characterized by not only low and falling per

capita income but also high dependence on a few primary exports, poor financial policies and widespread state intervention including price controls, a government-run distribution system and public ownership of strategic industries.

Thirteen of the 19 countries were experiencing severe debt-servicing crises, with rapid increase of external debt and accumulation of payment arrears. Public-sector deficits were large although the magnitude of the problem was not clearly quantifiable owing to a lack of information on the consolidated budget deficit. The fiscal affairs of most countries were characterized by poor control of expenditure, a weak tax administration with excessive tax exemption and transfers to public enterprises. Most public enterprises operated with significant losses or earned very low returns on investment and were therefore unable to generate resources for adequate investment. "The most serious problems were in the capacity to formulate and monitor the government budget, administer tax collection and manage externally funded public investment projects. Weak administrative capacity stemmed from a large but inefficient and unmotivated civil service" (p. 7).

Six of the 19 countries, including Guyana, Madagascar, Mauritania, Mozambique, Tanzania and Uganda, had comprehensive trade and foreign exchange controls with fixed and highly overvalued inconvertible currencies. Other countries, including Gambia, Lesotho, Niger, Senegal and Togo, did not have major restrictions on current account transactions. In most countries, interest rates were administratively controlled and most of the credit was directed towards the public sector.

An interesting observation of the paper is that "most of the 19 countries had begun the process of reform and macroeconomic stabilization often with IMF support prior to their SAF/ESAF arrangements" (p. 7). Nevertheless, the before and after SAF/ESAF evaluation that is done in the paper implicitly compares the SAF/ESAF programmes with the preceding stand-by arrangements.

During the implementation of the SAF/ESAF arrangements, exogenous factors, including low growth in industrialized countries and deteriorating terms of trade, affected countries implementing reforms. The group as a whole experienced a terms of trade deterioration of five per cent per year, though there was large diversity, with three countries actually recording an improvement in the terms of trade.[4] On the positive side, the SAF/ESAF arrangements were accompanied by an increase in the net resource flow at more concessional terms. This poses an empirical and analytical challenge regarding how to delineate the impact on economic performance in terms of policy reforms and exogenous factors. Unfortunately, the paper has not attempted to meet this challenge despite the presence in the Fund's Research Department of macroeconomists who have conducted some of the best applied research on this issue.[5]

### A. *Financial and structural policies of SAF/ESAF arrangements*

The two principal stated objectives of SAF/ESAF programmes are: to promote growth and attain balance-of-payments equilibrium while containing inflation. The actual policies recommended did not, however, show how full capacity output would be attained. The financial and structural policies of the SAF/ESAF arrangements aim at containing excess demand and addressing structural weaknesses. The interpretation of structural weaknesses, however, did not focus on the supply bottlenecks and the real side of the economy. "The strategy underlying the structural reform program was to strengthen the financial position of the public sector and reduce the government interference in the allocation of resources" (p. 9). In this regard, the SAF/ESAF arrangements did not differ from traditional IMF stabilization programmes that emphasize demand management and promoting efficient allocation of resources by removing government interference in the working of the market, including the foreign exchange market.

The guiding principle of reform of the public sector was to confine it to areas where the private

sector cannot perform. Removal of subsidies to public enterprises and their privatization were part of the policy objectives of SAF/ESAF arrangements. Public enterprise reform and privatization were normally handled by the World Bank while the IMF was concerned with the reduction of the government deficit. Lack of consolidated public-sector accounts made the central government deficit the target of policy. Ideally, for measuring the adjustment effort of the Government, the policy target should be the reduction of the primary current account deficit excluding grants.[6] In practice, the policy target was to reduce the current account deficit including official aid. The reduction of deficits could be attained by increasing government revenues through implementing tax reforms and/or by reducing expenditures as a result of prioritizing government programmes and eliminating untargeted government subsidies.

The paper points out that the SAF/ESAF programmes achieved an average reduction of the overall budget deficit as a percentage of GDP of 2 per cent, mainly as a result of an increase in revenues rather than a reduction in expenditure. The improvement in the overall deficit was mainly the result of an increase in external grants because primary current accounts excluding grants improved less or deteriorated more than the overall balance.

Other policies in the public sector included civil service reform that aimed at eliminating "ghost" workers, conducting comprehensive public expenditure reviews and introducing rolling public investment programmes. Capital expenditure relative to GDP increased in ten of the 19 countries; the increase was particularly large in Uganda and Mozambique. These countries were coming out of long civil wars and required large expenditures to rehabilitate their infrastructure. Excluding these two, public expenditure as a percentage of GDP decreased, on average, by one percentage point.

The reform of public enterprises was aimed at restructuring those strategic enterprises which were to remain within the public sector, closing non-strategic loss-making enterprises and privatizing non-strategic enterprises with commercial value. Public enterprise reform proved more difficult than anticipated. The paper admits that "the World Bank and IMF staff, as well as the authorities, underestimated the time required to design and implement reforms" (pp. 13-14). For most countries in the study public enterprises remained a significant burden on the government budget.

There was more progress in the reforming of marketing boards and trading companies. The objectives of reforms in these areas were to eliminate the monopoly of publicly owned marketing boards, to allow market forces to determine producer prices, and where marketing boards were not abolished, to improve their financial position at least. Some of the African countries, including Gambia, Niger and Uganda, implemented comprehensive reforms that liberalized the marketing system of agricultural products.

The most forceful reforms were in the exchange and trade system. Most countries at that time, except those in the CFA franc zone, massively devalued their currencies and liberalized their trade regimes by dismantling or reforming import licensing systems. It is noted that for most countries in the study, devaluation of the currency and trade liberalization started before adopting SAF/ESAF arrangements.

Financial sector policies were aimed at limiting the growth of credit, particularly to the public sector; eliminating government-directed credit and enhancing the role of the market in allocating credit; and encouraging the use of indirect means of controlling the money supply and strengthening the supervision capacity of the central bank.

In most countries, SAF/ESAF arrangements did not have a significant impact on containing the growth of the money supply. There was significant progress towards increasing real interest rates, however, mainly as a result of large increases in nominal interest rates, but most countries were reluctant to abandon direct means of monetary control and credit allocation. Only a

few countries introduced auctions of central bank securities and/or treasury bills. The paper notes that limited progress was attained in reforming financial institutions.

The social dimensions of adjustment are briefly discussed in the paper. It is argued that "reform initiatives have paid increasing attention to alleviating poverty and mitigating the social costs of adjustment. The World Bank and the IMF have collaborated in this area; the Fund staff has focused on budgetary and macroeconomic implications, and the Bank staff on longer-term poverty reduction" (IMF, 1993, pp. 20-21). As we shall see when reviewing the World Bank report on Africa, its interpretation of adjustment policies does not include longer-term development issues.

### *B. Impact of policies on economic performance*

The paper discusses how countries made progress towards achieving external viability and sustained economic growth. External viability is defined as "an overall external position and structure of the balance of payments consistent with sustainable inflows of normal financing" (p. 22). Movement towards external viability is assumed to have taken place when the debt-service ratio is reduced and exceptional financing is avoided. The paper notes that, given the initial high indebtedness, "external viability would be out of reach if financing needs had to be met exclusively by debt on market related terms" (p. 23). The discussion of viability assumed that these countries would continue to receive capital inflows on concessionary terms. The paper argues that there was significant progress in reducing debt service burdens among the countries that were implementing SAF/ESAF programmes. Both debt cancellation and growth of exports contributed to the reduction of the debt-export ratio.

On the basis of progress toward external viability, the paper divides the sample into two groups: countries that made relatively more progress and those that made relatively less progress towards external viability. Eleven countries, including seven in Africa - Gambia, Ghana, Lesotho, Malawi, Mozambique, Senegal, and Togo - are considered to have made major progress towards external viability because they reduced their debt service, reduced their resort to exceptional financing and avoided the accumulation of arrears during the ESAF period.

The paper argues that SAF/ESAF arrangements have led to an improvement in economic performance. The annual average GDP growth rate increased from 2.1 per cent in the pre-SAF or pre-ESAF period to 4.0 per cent during SAF and 2.8 per cent during ESAF. Export volume grew on average by 2.2 per cent before the implementation of SAF or ESAF arrangements. Its growth rate increased to 4.4 per cent during SAF and 7.3 per cent during ESAF (see table 1). It is asserted that the largest improvements in economic performance "occurred in countries that undertook forceful structural reform and that suffered the least from weakening terms of trade". The classification of countries is not based on policy implementation but on economic performance in the form of external viability.

The paper states that "generally, the countries with the best external and domestic performance undertook stronger financial adjustment measures than those where progress toward external viability and domestic performance was weaker. However, except in the area of fiscal policy, differences were not great" (p. 37). The empirical evidence provided in the paper shows that, on average, countries that made relatively little progress towards external viability undertook stronger financial adjustment measures in the form of larger depreciation of the real exchange rate and reduction of the growth rate of money supply, as shown later in this paper.

### *C. Shortcomings of the IMF paper*

The IMF paper *Economic Adjustment in Low-Income Countries* is more of a public relations exercise aimed at influencing the funding of the second ESAF facility than a serious attempt to analyze the impact of SAF/ESAF on the economic performance of low-income countries, particularly in Africa. The paper uses the "before and after"

***Table 1***

**MACROECONOMIC INDICATORS FOR 19 ESAF COUNTRIES[a]**
*(Per cent)*

| | "Pre-SAF or "Pre-ESAF" period[b] | "SAF" period | "ESAF" period | Most recent year[c] |
|---|---|---|---|---|
| Real GDP growth | 2.1 | 4.0 | 2.8 | 2.9 |
| Export volume growth | 2.2 | 4.4 | 7.3 | 7.3 |
| Inflation[d] | 16.9 | 15.0 | 13.3 | 17.6 |
| Savings/GDP | 6.9 | 8.7 | 8.5 | 10.2 |
| Investment/GDP | 14.9 | 18.5 | 20.7 | 19.7 |
| Current Account/GDP[e] | -12.3 | -15.4 | -18.0 | -16.8 |

***Source*:** IMF (1993), table 9.
***a*** Annual averages.
***b*** Average over three years preceding the first SAF- or ESAF-supported arrangement.
***c*** Calendar year 1991 or fiscal year 1991/1992.
***d*** Excluding Bolivia and Uganda.
***e*** Excluding official transfers.

approach without cautioning the reader as to the shortcomings of such a methodology, as raised by, among others, the IMF staff (Goldstein and Montiel, 1986). Because there is no consensus on how to evaluate the impact of IMF programmes on economic performance - as it is almost impossible to present a "counterfactual" account of what would have happened in the absence of a IMF programme - , the conclusion derived from a "before and after" approach must be highly qualified and supplemented with an "actual versus target" approach showing the intensity of policy implementation and whether policy objectives were actually achieved.

Moreover, most countries in the sample had stand-by arrangements with the Fund before adopting the SAF/ESAF arrangements. For these countries, such as Gambia, Ghana, Kenya, Malawi and Senegal, an analysis of economic performance before and after the SAF/ESAF arrangement is a comparison of the impact on economic performance of accessing two different types of IMF facilities. If countries performed better under SAF/ESAF, then the earlier stand-by arrangements should be faulted.

The paper focuses on SAF/ESAF arrangements without clearly delineating what role the Fund played relative to that of the World Bank. The World Bank economists tend to argue that the role of the Fund is stabilization, through restraining demand while the adjustment policies of the Bank stimulate supply (Husain, 1993). The SAF/ESAF arrangements were usually implemented in conjunction with World Bank Structural Adjustment Programs. The appropriate discussion should have been the impact of reform policies adopted rather than confining the assessment to SAF/ESAF arrangements. In this regard, the World Bank study, *Adjustment in Africa*, is methodologically superior to the IMF paper because it analyzes policies without necessarily associating them with access to a particular credit facility.

*Economic Adjustment in Low-Income Countries* does not attempt any rigorous statistical testing of the link between economic performance and policies undertaken. For example, it asserts that SAF/ESAF arrangements promoted growth on the basis of comparing the average growth rate over the three years preceding the first SAF or ESAF arrangement and the average growth rate during the SAF and ESAF period. As it turns out, the GDP growth rate during the pre-SAF/ESAF period was 2.1 per cent, increasing to 4.0 per cent during the SAF period, then falling to 2.8 per cent

*Table 2*

**CENTRAL GOVERNMENT BUDGET DEFICIT**
*(Per cent of GDP)*

| | | Three years before SAF/ESAF | One year before SAF/ESAF | Most recent |
|---|---|---|---|---|
| Progressors[a] | *Median* | -9.1 | -7.0 | -3.0 |
| | *Mean* | -12.6 | -9.9 | -5.7 |
| Non-Progressors[b] | *Median* | -7.2 | -3.6 | -4.1 |
| | *Mean*[c] | -8.2 | -3.9 | -3.9 |

***Source:*** IMF (1993), table 12.
*a* Countries that made relatively more progress toward external viability, including Bangladesh, Bolivia, Gambia, Ghana, Guyana, Lesotho, Malawi, Mozambique, Senegal, Sri Lanka and Togo.
*b* Countries that made relatively less progress toward external viability, including Burundi, Guinea, Kenya, Madagascar, Mauritania, Niger, Tanzania and Uganda.
*c* Excluding Guinea.

during the ESAF period when reforms were supposed to be especially vigorous. If SAF arrangements were responsible for increasing growth from 2.1 per cent to 4.0 per cent, were ESAF arrangements responsible for reducing growth to 2.8 per cent?

Current account deficits excluding official transfers worsened during the SAF and ESAF period (table 1) which indicates lack of improvement in the balance-of-payments position, although the paper asserts that there was a general improvement in external viability because of reduction of the debt-service ratio and avoidance of using exceptional financing. The conflicting evidence on external viability is not clarified. Some of the assertions and conclusions in this respect can be outright misleading. For example, Gambia, Ghana, Guyana, Lesotho, Malawi, Mozambique and Senegal are considered to be among the countries that moved towards external viability despite their heavy dependence on concessionary capital inflow.

The evidence purportedly linking progress towards external viability with stronger financial adjustment measures simply does not exist even in the fiscal area. Table 2 shows that among countries that made more progress towards external viability, the average central government budget deficit as a percentage of GDP decreased from 9.9 per cent a year before entering the SAF/ESAF arrangement to 5.7 per cent in the most recent year studied, i.e. 1991 or 1991/92. Countries that made less progress towards external viability did not reduce their average budget deficit as a share of GDP which was steady at 3.9 per cent a year before SAF/ESAF and the most recent year.

To conclude from these averages that the former ("progressors") had stronger financial policies than the latter ("non-progressors") is misleading. The non-progressors had reduced their average budget deficit as a share of GDP from 8.2 per cent three years before SAF/ESAF to 3.9 per cent a year before SAF/ESAF, compared to a reduction of 9.1 per cent to 7.0 per cent by the progressors during a similar interval. The non-progressors had undergone more adjustment than the progressors in the fiscal area before SAF/ESAF, presumably under an IMF stand-by arrangement. Although the non-progressors' average did not decrease after the SAF/ESAF arrangements, it was still 1.8 percentage points lower than the progressors.

Table 3 shows that the non-progressors had larger depreciation of the real exchange rate both before and during SAF/ESAF than did the

*Table 3*

**REAL EFFECTIVE EXCHANGE RATE**
*(Average annual percentage change)*

| | | Three years before SAF/ESAF | SAF | ESAF |
|---|---|---|---|---|
| Progressors | *Median* | -0.1 | -3.2 | -1.8 |
| | *Mean* | -0.8 | -7.9 | -2.4 |
| Non-Progressors | *Median* | -7.2 | -9.8 | -3.9 |
| | *Mean* | -13.5 | -20.1 | -8.6 |

***Source:*** IMF (1993), table 12.

*Table 4*

**GROWTH OF BROAD MONEY**
*(Per cent, annual averages)*

| | | Three years before SAF/ESAF | SAF | ESAF |
|---|---|---|---|---|
| Progressors | *Median* | 19.6 | 20.5 | 14.5 |
| | *Mean* | 23.1 | 26.4 | 19.4 |
| Non-Progressors | *Median* | 16.3[a] | 9.2[a] | 9.4 |
| | *Mean* | 41.1[a] | 36.3[a] | 19.2 |

***Source:*** IMF (1993), table 12.
***a*** Excluding Guinea and Tanzania.

progressors. The larger depreciation of the non-progressors did not lead to significant improvement in the balance of payments compared to non-progressors. On average, export volumes of non-progressors grew by only 2 per cent compared to 6.3 per cent by progressors during the three years ending in 1991 or 1991/92. Contrary to theory, large depreciation did not have the expected impact on external performance. The paper does not discuss the obvious contradiction and readers are left alone to discover it on their own in a crowded table.

Similarly on monetary policy outcomes, non-progressors reduced the growth of money supply by a larger percentage than progressors. As may be seen in table 4, the average growth rate of broad money in non-progressors was reduced from 41.1 per cent three years before SAF/ESAF to 36.3 per cent and 19.2 per cent during the SAF and ESAF periods. The progressors recorded an increase in the growth of broad money from an average of 23.1 per cent per year three years before SAF/ESAF to 26.4 per cent during SAF and then only decreased it to 19.2 per cent during ESAF.

The evidence on financial and exchange rate policy provided in the paper thus demonstrates the opposite of its purported conclusion. On average,

*Table 5*

**TERMS OF TRADE**
*(Average annual percentage change)*

| | | Three years before SAF/ESAF | SAF | ESAF |
|---|---|---|---|---|
| Progressors | *Median* | -1.9 | -2.2 | -0.8 |
| | *Mean* | 0.3 | -3.6 | -1.0 |
| Non-Progressors | *Median* | -2.1 | -5.1 | -7.3 |
| | *Mean* | 0.3 | -7.9 | -7.5 |

***Source:*** IMF (1993), table 12.

*Table 6*

**NET RESOURCE TRANSFER**
*(in per cent of GDP)*

| | | Three years before SAF/ESAF | SAF | ESAF |
|---|---|---|---|---|
| Progressor | *Median* | 6.9 | 20.1 | 16.2 |
| | *Mean* | 10.6 | 17.5 | 19.8 |
| Non-Progressors | *Median* | 13.5 | 19.0 | 18.7 |
| | *Mean* | 13.1 | 15.7 | 15.5 |

***Source:*** IMF (1993), table 12.

the countries with the best external and domestic performance undertook weaker adjustment measures compared to those where progress towards external viability and domestic performance was poorer. If the better performance of the progressors is not explained by stronger financial policies, it is probably explained by positive external developments. The evidence provided in the IMF paper shows that external factors, particularly terms of trade and net resource transfers, are positively associated with progress toward external viability. Progressors had, on average, smaller deterioration in their terms of trade and had a larger increase in net transfers than the non-progressors (see tables 5 and 6).

*Economic Adjustment in Low-income Countries* does not provide convincing evidence that SAF or ESAF arrangements have been successful in improving growth performance and balance-of-payments positions in low-income countries. A careful analysis of the evidence provided indicates that exogenous factors, particularly the terms of trade and net resource inflows, were more important than policy measures such as depreciation of the real exchange rate in improving the performance of the countries that accessed ESAF resources. If this paper was influential in convincing the IMF Board of Governors and donors to replenish ESAF, it was nevertheless a major success in public relations (and misinformation) on the part of the IMF management and staff.

## II. A review of "Adjustment in Africa: Reforms, Results and the Road Ahead"

The World Bank study *Adjustment in Africa* analyzes the impact of adjustment efforts on the economic performance of 29 sub-Saharan African countries that undertook structural adjustment programmes in the 1980s. According to the report, these adjustment programmes were undertaken to improve poor policies that were "the primary cause of the 15 per cent fall in Africa's per capita GDP during 1977-85" (World Bank, 1994, p. 3). The poor policies included: macroeconomic mismanagement, particularly overvalued exchange rates and high rates of inflation; highly protective trade régimes; government intervention in regulating markets and controlling prices, and heavy direct and indirect taxation of agriculture; over-extended roles for public enterprises; and government control and intervention in the operation of financial institutions.

### *A. The reforms and results*

The report concludes that for "the African countries that have undertaken and sustained major policy reforms, adjustment is working" (p. 1). However, while the report applauds the improvement in policies and their positive impact on growth and exports, it notes that policies do not go far enough, and even those countries that are doing the best job of reforming are not achieving growth rates that can significantly reduce poverty in the medium term. "With today's poor policies, it will be forty years before the region returns to its per capita income of the mid-1970s" (p. 36).

The 26 African countries examined have been classified into three groups. The first group comprises those countries that are considered to have undertaken significant macroeconomic policy reforms during 1987-1991 as compared to 1981-1986. The second group comprises those countries that had only a small improvement in macroeconomic policies during the same period. Countries in the third group had a deterioration of policies. The report's major finding is that the six countries that had the most improved macroeconomic policies - in rank order, Ghana, Tanzania, Gambia, Burkina Faso, Nigeria and Zimbabwe - also outperformed the other countries in terms of growth. The growth rate of per capita GDP increased by an average of 2 per cent, and export growth increased by 8 per cent between 1981-1986 and 1987-1991 (see table 7). In countries that improved their macroeconomic policies, undertook trade liberalization, and reduced the tax burden on the agricultural sector, there was a resurgence of growth in output, exports, agricultural production and manufacturing. While external transfers were deemed to have contributed to faster growth by relieving the import constraint, overall, policy reforms were found to have been more important than external transfers. However, as World Bank staff would readily acknowledge, the performance of all these countries remains inadequate: the growth rate of even the best-performing country, Ghana, is still too low to reduce mass poverty in the medium term. Even those African countries that have made large improvements in macroeconomic policies have not achieved the appropriate policy mix of unified exchange rates with no overvaluation or parallel market premium, low budget deficits, low rates of inflation, liberalized trade régimes, and wide privatization of public enterprises.

The report concludes that reforms have been weakest in the public sector - the pace at which public enterprises have been privatized has been very slow - and in the financial sector, where continuation of directed credit and monetization of public-sector deficits has been widespread. One of the objectives of structural adjustment programmes has been to reform public enterprises, but there is little evidence of any significant progress in this domain. By 1992, most countries had divested less than 10 per cent of their public enterprises, and only Guinea Bissau, Benin, Mali, Senegal and Togo had divested more than 40 per cent of such enterprises. Moreover, most of these divestitures consisted of small public enterprises that accounted for only a small proportion of government assets. In fact, according to the report, "the public sector lies at the core of the stagnation and decline in growth in

*Table 7*

**GROWTH OF GDP PER CAPITA AND EXPORTS, 1981-1991**

*(Per cent, annual averages)*

| | GDP per capita | | | Exports | | |
|---|---|---|---|---|---|---|
| Country | 1981-1986 | 1987-1991 | Swing *(percentage points)* | 1981-1986 | 1987-1991 | Swing *(percentage points)* |
| ***Large improvement in macroeconomic policies*** | | | | | | |
| Ghana | -2.4 | 1.3 | 3.7 | 4.5 | 8.1 | 3.5 |
| Tanzània | -1.7 | 1.3 | 3.0 | n.a. | n.a. | n.a. |
| Gambia | 1.2 | 0.3 | -0.9 | -0.6 | 11.3 | 11.9 |
| Burkina Faso | 2.2 | 0.4 | -1.8 | 0.0 | 5.3 | 5.4 |
| Nigeria | -4.6 | 2.4 | 7.0 | -5.5 | 4.9 | 10.3 |
| Zimbabwe | 0.3 | 1.0 | 0.7 | n.a. | n.a. | n.a. |
| *Mean* | *-0.8* | *1.1* | *2.0* | *-0.4* | *7.4* | *7.8* |
| *Median* | *-0.7* | *1.1* | *1.8* | *-0.3* | *6.7* | *7.9* |
| ***Small improvement*** | | | | | | |
| Madagascar | -3.7 | -2.1 | 1.6 | -7.6 | 6.1 | 13.7 |
| Malawi | -1.4 | 0.7 | 2.1 | 1.6 | 3.6 | 2.0 |
| Burundi | 2.1 | 1.2 | -0.9 | 11.8 | 4.9 | -6.9 |
| Kenya | -0.5 | 0.9 | 1.4 | 2.3 | 6.3 | 4.0 |
| Mali | 0.4 | -1.2 | -1.6 | 2.6 | 6.7 | 4.2 |
| Mauritania | -0.9 | -1.0 | -0.1 | 8.9 | -0.8 | -9.7 |
| Senegal | 0.4 | -0.2 | -0.6 | 6.1 | 0.9 | -5.2 |
| Niger | -4.9 | -2.4 | 2.5 | -7.1 | 0.2 | 7.3 |
| Uganda | -1.5 | 2.8 | 4.3 | n.a. | n.a. | n.a. |
| *Mean* | *-1.0* | *-2.6* | *-1.6* | *2.3* | *3.5* | *1.2* |
| *Median* | *-2.1* | *-2.0* | *-0.1* | *2.5* | *4.3* | *3.0* |
| ***Deterioration*** | | | | | | |
| Benin | 1.1 | -2.0 | -3.1 | 2.2 | -4.1 | -6.3 |
| Central African Republic | -0.1 | -2.8 | -2.7 | -3.6 | -4.4 | -0.8 |
| Rwanda | 0.4 | -5.0 | -5.4 | 4.5 | 2.1 | -2.4 |
| Sierra Leone | -2.1 | 0.8 | 2.9 | -10.5 | -0.8 | 9.7 |
| Togo | -2.8 | -1.4 | 1.4 | -1.4 | 2.7 | 4.1 |
| Zambia | -3.2 | -2.3 | 0.9 | -2.2 | -2.8 | -0.5 |
| Mozambique | -5.9 | 1.7 | 7.6 | - | - | - |
| Congo | 4.1 | -0.7 | -4.8 | 5.9 | 2.0 | -3.9 |
| Côte d'Ivoire | -4.2 | -6.8 | -2.6 | 3.9 | 4.9 | 1.0 |
| Cameroon | 4.6 | -7.9 | -12.5 | 13.7 | -11.8 | -25.4 |
| Gabon | -2.7 | -1.9 | 0.8 | 0.4 | 11.4 | 11.0 |
| *Mean* | *-1.0* | *-2.6* | *-1.6* | *1.3* | *-0.1* | *-1.4* |
| *Median* | *-2.1* | *-2.0* | *-2.6* | *1.3* | *0.6* | *-0.7* |
| ***Unclassified***[a] | | | | | | |
| Chad | 4.5 | 2.6 | -1.9 | 14.8 | 5.0 | -9.7 |
| Guinea Bissau | 2.9 | 1.5 | -1.4 | n.a. | n.a. | n.a. |

***Source:*** World Bank (1994), table A. 17 and A. 22.

*a* No data was available for Guinea.

Africa" (p. 99). The report notes that Governments had taken on too much: "intervening - with poor results - in activities where markets work reasonably well, such as allocating foreign exchange and directing credit" (p. 99). Overextension and poor performance of the public sector are attributed to the lack of an indigenous capitalist class and the dominance of foreign companies and non-indigenous capitalists in the modern industrial and services sectors. Public enterprises were given privileged access to credit and foreign exchange but were not run commercially and tended to have multiple objectives. In all of these countries, they have been a major drag on the state budget, the banking sector and other quasi-fiscal sources of revenue.

The report stresses the importance of a sound, efficient financial system on economic growth but notes that "financial systems in sub-Saharan Africa have traditionally been characterized by weak resource mobilization, high credit losses, high intermediation costs, and excessive political interference" (p. 110). None of the countries studied has a financial system that efficiently and effectively operates the payments system, mobilizes savings, allocates financial resources to productive investment activities, facilitates domestic and international trade or provides investment portfolios for diversifying risk.

The report credits the low rate of savings in these African countries - just 15 per cent of GDP, on average - "to negative real interest rates, lack of confidence in the banking system, and political and macroeconomic instability, leading people to maintain savings in more tangible assets or to send their capital abroad" (p. 110). The report finds that the financial reforms undertaken to reduce financial repression, restore solvency of financial institutions and improve the financial infrastructure have had only limited success, and that "financial systems continue to finance the deficits of the central Government and the overextended public enterprise sector" (p. 113). The report concedes that there has been some progress in reducing financial repression. For example, by late 1992, Burundi, Gambia, Ghana, Kenya, Madagascar, Malawi, Mauritania and Zambia had fully liberalized interest rates, while other countries had set reasonable minimum and maximum rates or had regulated the spread between lending and deposit rates. Some countries have succeeded in reducing the level of directed credit and in closing several development finance institutions. The restructuring of financial institutions, which was focused on cleaning their balance sheets and recapitalizing them, generally has not been successful because the real economy is dominated by parastatels, which do not operate commercially but continue to have access to credit. Moreover, the report notes that the cost of restructuring can be excessively high - between 1.5 and 2.0 per cent of GDP in Ghana, Guinea and Madagascar and a staggering 40 per cent of GDP for a partial restructuring in Tanzania. In most of these countries, supervisory capacity within the central bank or Government is lacking.

The World Bank report notes that "achieving better management in the public sector is essentially a long-term development objective" (p. 120). It identifies three general problems in African policies in the public sector: the civil service has expanded faster than the economy; high employment growth has received priority over income growth; and the larger pay increases for lower ranks and sharp decreases in the real incomes of the professional ranks have reduced incentives and promoted inefficiency.

The short-term objectives of reforms in the public sector have been to "trim the civil service to a manageable size, increase real public-sector wages to reasonable levels where necessary, get control of the payroll system, eliminate the worst 'white elephants' from investment programs, create a rolling investment plan that includes all the investment projects being undertaken, and reform tax policy and administration" (p. 121). The results of reform have so far been mixed. Some countries, including Cameroon, Ghana, Guinea, Tanzania and Uganda, have reduced employment by exorcising payroll "ghosts", but few countries have effective control over their payroll systems. Control and monitoring of public expenditures remain inadequate. Many countries have been unable to target public investment or to concentrate expenditures, including foreign aid, on priority areas.

The report notes that tax reforms in sub-Saharan Africa have been driven by short-term revenue considerations, and have not succeeded in significantly raising the ratio of tax revenue to GDP. Some countries have attempted to improve their tax administration procedures by introducing value-added taxes and by reducing the number of taxpayers to a level compatible with administrative capability. The report, however, does not undertake a comprehensive assessment of tax reforms in these countries.

The report includes a chapter on "poverty and the environment", which is relatively brief (19 pages) and rather short on empirical evidence. The report notes that "the share of people living in poverty is larger in Africa and the poor are poorer than in any other region", and that "Africa is the only part of the world where the number of the poor is increasing" (p. 161). Slow economic growth, rapid population growth, and a fragile environment make the task of reducing poverty particularly difficult, yet efforts to reduce poverty can have a high payoff for the environment because "the poor are both the victims and the agents of damage to the environment" (p. 161).

*Adjustment in Africa* disputes charges that structural adjustment often hurts the poor and argues that "often the poor would have benefited from more adjustment, not less - from more fundamental reform of agricultural marketing, more complete exchange rate unification and real depreciation, and more radical reform and redistribution of public spending" (p. 163). The report accepts criticism by the United Nations Children's Fund (UNICEF) "that many adjustment programs launched early in the 1980s did not pay enough attention to ensuring adequate provision of services to the poor" (p. 163). However, it asserts that

> "since the late 1980s, more effort has gone into improving the composition of public expenditure and the delivery of social services. Policy reforms undertaken in the course of adjustment programs can lay the broad foundations for better social policies, but long-term development efforts to improve the delivery of social services must also be pursued to complement adjustment policy reforms" (pp. 163-64).

The report argues that while economic decline during the early 1980s has hurt the poor, adjustment reforms that restored growth "in all likelihood reduced the deterioration in the conditions of the poor" (p. 165). This was because adjustment policies removed many disincentives to production of tradable goods and increased the profitability of agricultural activities, both of which benefited people in rural areas, where the bulk of the poor lives. The report also notes that although adjustment programmes have not reduced current expenditures, the allocation of public expenditures in the social sector have not been targeted towards areas that offer a large payoff in poverty reduction such as primary education (particularly for girls), preventive medicine and population planning.

On the question of the environment, the report notes that the lack of empirical studies makes it difficult to document the impact of adjustment on the environment. However, it maintains that sound pricing policies for energy, fertilizer and water resources can reduce wasteful distribution and consumption. Appropriate pricing and taxation of natural resources and reform of property rights and land-tenure systems can reduce the adverse impact of the "tragedy of the commons" and hence can improve environmental protection. More adjustment, and not less, will help the poor and the environment, concludes the World Bank.

### B. The road ahead

In looking to the future, the report argues that there is consensus on the direction of further reforms in at least three areas:

- Macroeconomic stability: countries should establish and maintain realistic exchange rates, keep budget deficits and inflation low, and increase public-sector savings;
- Promotion of agricultural growth: countries should liberalize agricultural marketing and reduce taxation of farmers by restructuring or abolishing marketing boards; they also should seek to ensure that the regulatory framework is

conducive to promoting private-sector participation in marketing activities;

- On trade policy: countries should move to market-based and hence automatic allocation of foreign exchange, undertake tarification of non-tariff barriers, and increase support to exporters, including relief from import duties.

The report notes that there has been little progress and less consensus on how to proceed on reforming public enterprises, financial institutions and public-sector management. Without movement in these areas, it will be difficult to sustain macroeconomic stability, mobilize savings, efficiently allocate loanable funds toward productive investment, and provide basic services to the poor. Research and debate on how best to proceed in reform of the public sector and financial system are warranted. The biggest challenge, the report notes, is "to build a more effective civil service to provide the elements necessary for a well-functioning market economy, including a sound macroeconomic framework, well-managed public finances, an adequate legal framework, and a system for delivering essential services to the poor to promote growth and equity" (p. 197).

On the reform of public enterprises, the report discusses two contending schools of thought. The first holds that privatization is necessary to promote efficiency and to signal an overall commitment by the Government to a development strategy led by the private sector. According to this view, "all commercially viable public enterprises - and those with the potential to become viable - should be privatized" (p. 197). "Natural monopolies" could be handled by leasing arrangements or incentive-based contracts with private companies.

"The second school of thought favours enterprise rehabilitation through the use of hard budget constraints and deregulations" (p. 198). The report dismisses the hard budget constraint as a "soft option" which is unlikely to be implemented in practice. Therefore, the report favours accelerating privatization.

On reform of the financial sector, the report notes that "the most urgent challenge facing African financial systems is to get back to basics: operating a sound and efficient payment system, maintaining safe and sound banking, allocating credit efficiently and enforcing financial discipline" (p. 204). This requires a continuation of current policies to remove financial repression; dismantle directed credit programmes; establish better accounting, legal and supervisory frameworks; and develop capital and money markets. The report warns against premature efforts to restructure balance sheets before addressing the problems of the borrowers, including private enterprises and parastatel organizations. In undertaking financial reforms, countries need to strike a balance between promoting competition in the financial sector and ensuring solvency of financial institutions. Governments should require higher-than-normal capital-adequacy ratios and should rely on reputable foreign banks when necessary. The report recommends downsizing troubled banks and granting management and performance contracts to reputable private banks to run state-owned banks until private buyers come forward to purchase them.

*Adjustment in Africa* notes that although African countries are highly indebted, external debt has not caused cash flow problems, except in the cases of Nigeria and Congo. It recommends that both debt relief and additional aid to these countries should be made conditional on the adoption of comprehensive reform programmes. The report also recommends that in seeking to reduce debt stocks to sustainable levels, the objective should be to do so in a manner that preserves the countries' access to concessional financing - which requires continued prompt servicing of the multilateral debt. The report warns that large volumes of aid can lead to soft budget constraints and distortions in the markets for labour and capital, and therefore it recommends that aid flows should be conditional on adoption of sound and comprehensive reform programmes.

In order to promote economic growth, the report urges African Governments to be guided by

three principles in undertaking reform programmes (pp. 182-83):

- "Keep budget deficits low and the exchange rate right";
- "Foster competition at home and abroad" through domestic deregulation, trade reform and hard budget constraints; promotion of exports should be given first priority.
- "Use scarce government resources wisely" by, among other things, abolishing marketing boards, privatizing public enterprises, unifying foreign exchange markets, replacing import restrictions by tariffs, and rationalizing tariff structures.

In addition to these measures, the report urges that financial sector reforms be focused on reducing financial repression by liberalizing interest rates, restoring bank solvency and improving the financial infrastructure by downsizing state-owned banks, privatizing them where possible, encouraging new entrants who have a solid capital base, and relying on foreign banks.

### *C. The strengths of the World Bank report*

The major strength of *Adjustment in Africa* is that its analysis of the impact of reforms in African countries is based on measurements of change in macroeconomic policy stance, trade liberalization, taxation of agricultural exports, and interventionist government policies in prices and marketing. Unlike the World Bank's earlier report "Africa's Adjustment and Growth in the 1980s" (World Bank, 1989), this report does not arbitrarily classify countries as strong, moderate or weak reformers but attempts to quantify the extent of policy reform using empirical evidence.[7] This is a difficult task, given the absence of good data and broadly accepted measures of macroeconomic policy stance or governmental intervention. The analytical and empirical effort is highly commendable.

The extent to which macroeconomic policy has changed in these countries is measured using variables describing fiscal, monetary and exchange rate policies. The fiscal variables include changes in budget deficit (excluding grants) and tax revenue, both as a percentage of GDP. The changes in monetary policy are measured using two indicators: the inflation rate and seigniorage, which is the revenue that Governments generate by exercising their exclusive privilege to print money. The exchange rate policy stance was measured using the parallel market premium and the real effective exchange rate (used for countries with flexible exchange rates and non-convertible currencies). Since countries with fixed exchange rates and convertible currencies, such as the member countries of the CFA, have no parallel market for foreign exchange, the report compared changes in the real effective exchange rates of these countries to those of non-African countries with similar export structures and which were therefore competitors of these African countries in the world market.

The impact of macroeconomic policies on growth was rigorously tested by the Bank by running regressions using the change in the growth rate of per capita GDP between the periods 1981-1986 and 1987-1991 as the dependent variable and macroeconomic policy variables, net external transfers, terms of trade, and the growth of GDP per capita during 1981-1986 as explanatory variables. Several interesting correlations were demonstrated, and the report concludes that: improvement in macroeconomic policies is correlated not only with larger changes in the rate of GDP per capita growth but also with higher levels of growth. Countries that improved macroeconomic policies the most had positive rates of GDP per capita growth during 1987-1991, while those whose policies deteriorated had negative rates (pp. 139-141). The report is careful, however, to point out that:

> Adjustment policies, though instrumental in generating the conditions for higher growth, are thus only part of the solution. Shifting economies to a new growth path requires a good overall policy environment and a better use of more traditional development instruments, such as investment in education and infrastructure (p. 141).

The report argues that agriculture, manufacturing and exports have responded positively to adjustment policies and strongly disputes assertions that structural adjustment programmes are causing a de-industrialization of Africa. It does not dispute, however, that there was no quick response to adjustment in the form of either investment or saving. There was no rigorous empirical testing of the impact of macroeconomic policies on agricultural output, manufacturing value added, exports, investment or saving.

### *D. Shortcomings of the World Bank report*

At several points, the World Bank report distinguishes between adjustment and long-term development policies. For example, perhaps to preempt criticism of the missing link between adjustment policies and long-term development policy, Michael Bruno, the Bank's chief economist, writes in the foreword:

> Adjustment programs are necessary but not enough to raise economic growth. As discussed at length in *Sub-Saharan Africa: From Crisis to Sustainable Growth*, investments in human capital and infrastructure, efforts to build the economic institutions necessary to a well-functioning market economy, and initiatives to increase technical capacity must also continue apace. This report, with its focus on adjustment, is intended to complement other World Bank publications dealing with various facets of Africa's long-term development strategy (p. xi).

The report also very explicitly states that:

> Adjustment alone will not put countries on a sustained, poverty-reducing growth path. That is the challenge of long-term development, which requires better economic policies and more investment in human capital, infrastructure, and institution-building, along with better governance" (p. 2).

This distinction between adjustment and long-term development policies can be confusing. In another World Bank report (Corbo and Fischer, 1991) it is argued that "the World Bank has been supporting structural adjustment in developing countries since the late 1940s. Initially, the support took the form of preparing and financing projects, especially in the area of infrastructure" (Corbo and Fischer, 1991, p. 1). Two of the editors of this 1991 volume argue that "structural adjustment programs seek to achieve both a long-term macroeconomic stabilization and structural transformation of the economy by addressing the fundamental causes of the country's economic crisis" (Corbo and Fischer, 1991, p. 7).

Yet, this broader objective for adjustment cannot be attained by removing distortions in product and factor markets in the absence of public investment that "crowds in" private investment and institution-building. The link between adjustment policies and long-term development policies must be explicit, particularly in the priorities for governmental expenditures. Policies - such as investment in human capital and infrastructure - that lead to long-term development take a long time to bear fruit, but they must be initiated during the adjustment period if development is to be achieved as soon as possible. Most African Governments have no long-term development policies beyond their stabilization and structural adjustment programmes. If the structural adjustment programmes do not address the issues related to long-term development, then they will not be part of the Governments' development policies.

If the objective of structural adjustment programmes is to restore and increase economic growth and thereby to reduce poverty, then short-term stabilization and adjustment policies must be designed so that they establish a framework for sustainable medium- and long-term growth. A review of structural adjustment programmes in African countries that analyzed the extent to which adjustment policies were establishing the basis for such medium- and long-term growth by improving basic infrastructure, investing in human resources and capacity, and increasing domestic capacity for policy formulation and implementation would have been much more relevant to the issue of long-term growth and development than *Adjustment in Africa*.

The report discusses reform of public enterprises, civil service reform and public-sector management, financial-sector reform, and the impact of adjustment on the poor and the environment - all of which are long-term development issues that cannot be addressed within a short period. In Africa, even macroeconomic stabilization objectives such as achieving sustainable current account balances, low budgetary deficits, and inflation rates of less than 10 per cent remain elusive even after a decade of stabilization and adjustment: in reality, they have become long-term development policy objectives.[8] In this context, the report's failure to take a longer-term perspective is a significant shortcoming.

The report concludes that reforms are working and have a high pay-off, but are not being fully implemented in many countries. While it does not directly address the question of why implementation falls short it does suggest that the elites in many countries undermine reforms (see pp. 217-228) and that heavy aid inflows can reduce the appetite for reforms (see pp. 215-216); it also makes some recommendations for overcoming these effects. Overall, however, the report seems to be based on unguarded optimism, and an overselling of the results that can be achieved through reform in the short run. Overselling the potential of reform to produce large benefits in the short run may contribute to cynicism and mistrust of reforms. Early assessments of the market-oriented reform programme undertaken in Chile in the mid-1970s deemed the programme a failure, although in the longer run (and after several policy reversals) the reforms have proved quite successful (Edwards and Cox-Edwards, 1987). In fact, some types of reforms, including fiscal retrenchment, privatization of public enterprises and financial liberalization, may lead to short- and medium-term increases in unemployment and reductions in output before the resulting efficiency gains and new investment ultimately produce significant increases in output, real incomes, and employment - the so-called J-curve effects.

A dominant opinion among intellectuals in Africa is that structural adjustment programmes are part of the problem rather than part of the solution to the African economic crisis. Few African government officials defend such programmes; most will argue that structural adjustment policies have been imposed on Governments by the IMF and World Bank (UNECA, 1989). A critical discussion of the process by which structural adjustment policies are designed and implemented and the extent to which African Governments (as opposed to the World Bank and the IMF) take the lead role could shed light on the problems of implementation.

*Methodological issues*

The report's econometric analysis of the impact of macroeconomic policies is confined to measuring the change in the growth rate of per capita GDP. No similar analysis is reported for the growth of agricultural output, manufacturing value-added, exports, saving or investment. In fact, table 8, based on data in the World Bank report, shows no significant improvement in the growth of agricultural output and manufacturing for those countries that had large improvements in macroeconomic performance compared to those that had small improvements. One wonders whether a regression analysis that attempted to link sectoral performance to changes in macroeconomic policies might yield poor results.

The econometric results reported in *Adjustment in Africa* (p. 140) show that change in the growth of GDP per capita between 1981 to 1986 and 1987 to 1991 is largely explained by macroeconomic policies. Net external transfers had an insignificant impact on growth, and improvements in the terms of trade had a negative impact on growth. These findings are not supported by other researchers. *The World Development Report 1992* concluded that "total official flows ... have a positive, independent influence on growth in the low-income countries on average ... in sub-Saharan Africa. Such flows are positively associated with growth" (World Bank, 1992). Other studies have shown a positive and statistically significant correlation between increased imports and improved growth. Both external transfers and income from changes in the terms of trade improve import capacity, which

***Table 8***

**GROWTH OF VALUE-ADDED IN AGRICULTURE AND MANUFACTURING, 1981-1991**

*(Per cent, annual averages)*

| | Agriculture | | | Manufacturing | | |
|---|---|---|---|---|---|---|
| Country | 1981-1986 | 1987-1991 | Swing *(percentage points)* | 1981-1986 | 1987-1991 | Swing *(percentage points)* |
| ***Large improvement in macroeconomic policies*** | | | | | | |
| Ghana | -0.2 | 2.0 | 2.2 | -0.4 | 4.5 | 4.9 |
| Tanzania | 3.4 | 5.3 | 1.9 | -4.5 | 3.3 | 7.8 |
| Gambia | 7.4 | -2.6[a] | -10.0 | n.a. | n.a. | n.a. |
| Burkina Faso | 5.0 | 2.7 | -2.3 | -0.3 | 6.3 | 6.6 |
| Nigeria | 1.2 | 3.9 | 2.7 | 0.6 | n.a. | n.a. |
| Zimbabwe | 5.3 | 0.6 | -4.7 | 2.7 | 4.2 | 1.5 |
| *Mean* | *3.7* | *2.0* | *-1.7* | *-0.4* | *4.6* | *5.2* |
| *Median* | *4.2* | *2.4* | *-0.2* | *-0.3* | *4.4* | *5.8* |
| ***Small improvement*** | | | | | | |
| Madagascar | 1.6 | 2.5 | 0.9 | n.a. | n.a. | n.a. |
| Malawi | 1.6 | 3.9 | 2.3 | 3.0 | 5.4 | 2.4 |
| Burundi | 4.1 | 2.5 | -1.6 | 6.1 | 6.6 | 0.5 |
| Kenya | 3.4 | 3.1 | -0.3 | 4.2 | 5.3 | 1.2 |
| Mali | 0.5 | 0.4[a] | 2.5 | n.a. | n.a. | n.a. |
| Mauritania | 3.1 | 1.9 | -2.7 | n.a. | n.a. | n.a. |
| Senegal | 4.1 | n.a. | -2.2 | 5.8 | 5.6 | -0.3 |
| Niger | 3.4 | 4.7 | n.a. | n.a. | n.a. | n.a. |
| Uganda | -1.8 | 2.7[b] | 6.4 | -6.3 | 17.2[b] | 23.6 |
| *Mean* | *2.2* | *2.8* | *0.7* | *2.6* | *8.0* | *5.5* |
| *Median* | *3.1* | *n.a.* | *0.3* | *4.2* | *5.6* | *1.2* |
| ***Deterioration*** | | | | | | |
| Benin | 4.7 | 4.6 | -0.1 | 7.8 | 5.8 | -2.0 |
| Central African Republic | 3.0 | 0.1 | -2.9 | n.a. | n.a. | n.a. |
| Rwanda | 0.2 | 0.2 | -0.1 | 3.2 | -0.2 | -3.4 |
| Sierra Leone | 1.9 | 3.3 | 1.4 | 5.2 | 6.3 | 1.1 |
| Togo | 5.2 | 3.4 | -1.8 | -0.4 | 8..3 | 8.7 |
| Zambia | 3.8 | 2.1 | -1.6 | 2.0 | 4.7 | 2.8 |
| Mozambique | -0.9 | 4.3 | 5.2 | n.a. | n.a. | n.a. |
| Congo | 2.3 | 4.2 | 1.9 | 11.2 | 3.3 | -7.9 |
| Côte d'Ivoire | -4.0 | 4.2 | 8.2 | n.a. | n.a. | n.a. |
| Cameroon | 3.6 | -1.1 | -4.7 | 17.2 | n.a. | n.a. |
| Gabon | 1.4 | 2.9 | 1.5 | 4.8 | 20.0 | 15.3 |
| *Mean* | *1.9* | *2.6* | *0.6* | *6.4* | *6.9* | *2.1* |
| *Median* | *2.3* | *3.3* | *-0.1* | *5.0* | *5.8* | *1.1* |
| ***Unclassified*** | | | | | | |
| Chad | 2.0 | 8.9 | 6.9 | 1.9 | n.a. | n.a. |
| Guinea | n.a. | 2.5 | n.a. | 4.6 | n.a. | n.a. |
| Guinea Bissau | 7.7 | 2.7 | -5.0 | n.a. | n.a. | n.a. |

***Source:*** World Bank (1994), tables A. 20 and A. 21.
*a* 1987-1990 .
*b* 1984-1996.

should have a favourable impact on growth. The econometric results reported can be misleading; a more appropriate econometric analysis of the determinants of economic growth should have taken a longer time frame. Econometric analysis by Elbadawi (1992) found very weak evidence of Structural Adjustment Programmes promoting growth in Africa.

*Exogenous factors*

The report grossly underestimates the impact of external factors on the economic performance of all of these African countries. The collapse of the terms of trade and increases in interest rates are considered to be unimportant. However, the fact that African countries as a group have lost market share does not necessarily imply that declining terms of trade have been unimportant to all of these countries. For example, Côte d'Ivoire was praised as a good performer in the 1970s because it did not excessively tax its agricultural sector and because it increased primary export market shares, promoted private investment, and maintained a market-friendly environment. It was argued that the "Ivorian miracle" was man-made - the result of good government policies (World Bank, 1987).[9] In 1977, nobody predicted the collapse of primary commodity prices. Regardless of the fact that they did make unproductive investments, it is undeniably true that Côte d'Ivoire and other successful primary exporters would be in better economic shape today if commodity prices had not collapsed and if real interest rates had not increased. Should Côte d'Ivoire strive to increase its market share for cocoa despite collapsing prices?

According to *Adjustment in Africa*, increased foreign assistance partially compensated for losses caused by deteriorating terms of trade. Not considered to have been decisive are the multiplier and growth-promoting effects of good export prices which are passed to producers. They encourage production, saving and investment, and cannot be attained through foreign assistance. According to the report this is, in part, "because marketing boards and trade taxes have generally stabilized the real producer prices of exports" (p. 26). Giving appropriate weight to terms-of-trade shocks does not constitute an attempt to blame the world trading system and ignore domestic policy mistakes. Such an approach does, however, provide a realistic view of the enormity of the problem of structural transformation. For example, it would be a mistake for Zambians to think that good policies - an appropriate exchange rate, trade liberalization and privatization - would bring per capita income back up to the levels of the 1960s and early 1970s. Rental incomes from copper mining are gone forever, and new production activities, largely in agriculture, have to be developed. The task of development is to increase the capacity of countries to respond to terms-of-trade shocks and to diversify their export basket. This requires, among other things, strong incentives to produce for export. Downplaying the effects of terms-of-trade shocks can rekindle an acrimonious and unproductive debate about the relative importance of internal versus external causes of the African crisis, to the detriment of efforts to find the best ways to build the capacity of these countries to respond to declining terms of trade.

*Adjustment in Africa* recognizes the enormity of the debt burden facing African countries but recommends that debt reduction be conditional on the adoption of strong structural adjustment policies. Most African countries, whether adjusting or not (with the possible exception of Zimbabwe) cannot service their debt. Linking debt cancellation to World Bank- and IMF-sanctioned stabilization and adjustment policies would have the effect of holding these African countries hostage. Strong adjustment programmes that are designed independently in each country, with the active participation of the people of the country in question, are more likely to be implemented. Significant across-the-board debt reduction can offer countries a new start. The current rescheduling exercises, which provide temporary cash flow relief, only perpetuate the debt crisis. The problem of debt overhang discourages private investment. Repeated debt rescheduling negotiations overburden policy-makers, and thereby contribute to poor policy formulation and implementation (Martin, 1991; Helleiner, 1993).

The policy recommendation of *Adjustment in Africa* has a simplistic free-market orientation. It emphasizes privatization of public enterprises as one of the means of confidence-building for the private sector without addressing the political economy problem of promoting indigenous entrepreneurs in the formal sector. Agricultural production and productivity are expected to be increased by removing direct and indirect taxation of farmers and letting free markets set the prices of inputs and outputs. Successful agricultural transformation in less developed countries elsewhere, however, was not based on a free-trade strategy but rather on government involvement not only in supporting research but also in setting producer prices and subsidizing inputs particularly at early stages of introducing new technologies.

The World Bank report asserts that "more adjustment not less would help the poor and the environment" (p. 14). This assertion is based on the following logic: because most of the poor live in rural areas that produce traded agricultural products, exchange rate adjustment and trade liberalization will improve the terms of trade of agricultural producers thereby benefiting the rural poor. Even if the rural poor have access to productive land, imperfect and incomplete markets and poor infrastructure may limit the pass-through of exchange rate adjustment to rural producers. In the early stages of liberalization, traders and transporters are likely to be the main beneficiaries. The poorest of the poor are net buyers of food. They will be hurt by trade liberalization that increases food prices (Cornia et al., 1992).

The main objective of exchange rate adjustment is to increase competitiveness by reducing the domestic cost of production, particularly the real wage. Households in both rural and urban areas that are dependent on wage incomes will experience a reduction in real incomes, while profit earners will see their incomes increased. It is only when output is responsive to the changed incentives and there is an increase in the demand for labour that real wages may start to increase - and this may take a long time. These may be the necessary costs of adjustment but *Adjustment in Africa* paints an unrealistically optimistic picture of the ability of devaluation and trade liberalization to improve the living standards of the poor (see tables 7 and 8).

## III. Comparison of the two studies

All the 15 African countries except Lesotho that were included in the sample of 19 countries covered by the IMF study are also included in the sample of 29 African countries included in the World Bank study. For an outsider, it is surprising that the two studies completely ignore each other. The IMF paper refers to *Adjustment in Africa* in a minor footnote pointing out that the debt service burden can be measured as the ratio of the present value of future debt service payment to current exports. The World Bank study includes *Economic Adjustment in Low-Income Countries* in its bibliography but no attempt is made to compare the findings of the two studies. In designing structural adjustment programmes, the two institutions are supposed to cooperate, particularly in the preparation of the policy framework paper; it would be logical to have closer cooperation in evaluating the impact of adjustment policies.

The time period covered by the two studies is roughly similar. The IMF study covers the period 1983-1991; however, it uses each country's signing of a SAF or ESAF arrangement as its reference point. The evidence of economic performance reported in the two studies does not necessarily refer to similar calendar years. The World Bank report is better organized and measures changes in macroeconomic policies between 1981 to 1986 and 1987 to 1991. Receipt of a structural adjustment loan is not used as the basis for analysing performance; rather, analysis is based on the actual policies pursued in the countries included in the sample.

The IMF study classifies the countries studied into two groups, according to progress towards external viability. The World Bank study classifies countries into three groups - countries with large improvement, small improvement and

deterioration in macroeconomic policies. Among countries that are classified as having large improvement in macroeconomic policies, Ghana, Tanzania and Gambia are included in the World Bank study. Ghana and Gambia are classified as good performers while Tanzania is a poor performer, according to the classification in the IMF study. Among countries that are classified as having deterioration in macroeconomic policies in the World Bank study, only two, Mozambique and Sierra Leone, are included in the IMF study and both are classified as good performers. Most countries that appear in both studies are classified by the World Bank as having small improvement in macroeconomic policies. Two of these, Malawi and Senegal, are classified as good performers in the IMF study, while others - Madagascar, Burundi, Kenya, Mauritania, Niger and Uganda - are classified as poor performers. The two institutions that are supposed to cooperate in designing adjustment policies of low-income African countries have conflicting assessments of their performance.

On specific causes of economic performance, the casual empirical evidence in the IMF study shows that external shocks, particularly terms of trade and net resource inflow, are important causes of improvement in economic performance. Large depreciation in the real effective exchange rate is not correlated with improvement in external viability or export performance. The World Bank argues that its econometric study shows that improvements in macroeconomic policies, including the depreciation of the real exchange rate, are statistically significant causes for a turn-around in growth of GDP while terms of trade changes show the wrong sign and net external inflows are statistically insignificant.

Both studies observe that public enterprise and financial sector reforms have not progressed as fast as anticipated when reforms had been introduced. The process of designing and implementing reforms is not analyzed in either study and hence it is not possible to infer from them how the design and implementation of reforms could be improved. They are left resorting to general statements such as the need for "political will" in implementing economic reforms.

## IV. The design and sequencing of structural adjustment programmes

The World Bank introduced adjustment lending in 1979 in order to provide quick-disbursing loans in support of policy changes and institutional reforms designed to attain sustainable current account deficits and to lead to more efficient resource allocation. Sectoral adjustment loans were provided to assist countries in meeting the transition costs of structural changes in industry and agriculture by increasing the availability of foreign exchange. The loans also were expected to be a catalyst for inflows of other external capital. The rationale for disbursing loans quickly was that, because the policy changes and institutional reforms would have balance-of-payments implications, successful implementation would require an increase in resource inflow. Moreover, the productivity of development projects already had been reduced in these countries because of the overall macroeconomic instability and government intervention that the adjustment programmes were designed to address and which had led to low saving and inefficient investment in the private sector (Stern, 1983; 1991).

The agenda of policy reforms typically involved in structural adjustment programmes has included: macroeconomic stabilization; liberalization of foreign exchange allocation, trade, interest rates, prices, and agricultural marketing; institutional reforms such as the privatization of public enterprises; financial-sector reforms; restructuring of public expenditures; and civil service reforms. Given the long agenda of adjustment policies typically undertaken, and in light of the experiences of earlier reformers (particularly Chile), appropriate sequencing of the reforms is essential for successful implementation of an adjustment programme. Closer coordination between the IMF and the World Bank is necessary so as to help ensure the success of adjustment programmes, particularly since the objective of both organizations is to foster macroeconomic stability. Such cooperation, lacking in the early 1980s, has increased, although the level of cooperation varies from country to country and, over time, within countries.

### *A. Appropriate sequencing of reforms*

In order to attain macroeconomic stability and to make an economy market-oriented and responsive to relative price changes, it is typically argued, largely based on the Latin American experience (Edwards, 1984), that reforms should be undertaken in the following sequence:

(1) exchange rate adjustment and the liberalization of domestic product and factor markets;
(2) liberalization of international trade, focusing on removing restrictions on imports of intermediate and capital goods and promoting exports before quantitative restrictions are lifted for imports of consumer goods that are domestically produced;
(3) liberalization of domestic financial markets after both the budget deficit and the inflation rate have been drastically reduced;
(4) external liberalization - the opening up of capital account transactions for purposes other than promoting direct foreign investment - at a pace dependent upon the success of the other policies in promoting growth and exports.

Each of these steps will be examined in turn.

#### *1. Exchange rate adjustment and liberalization of domestic product and factor markets*

Efficient resource allocation requires mobility of factors and competitive markets for products. Most African countries had imposed a plethora of controls on agricultural markets, particularly for export crops. Official monopolies have controlled the purchase and export of traditional export crops in most countries, regardless of the official political ideology. These controls went beyond those needed for capturing economies of scale in agricultural marketing or for stabilizing prices. In fact, official monopolies taxed agricultural producers, with the result that the domestic terms of trade facing agricultural producers worsened to a greater extent than the international terms of trade. The loss of market share by African producers of traditional export products is partly explained by these inefficient marketing systems and controls.

In some African countries, particularly those that attempted to establish socialist economies, such controls extended even to domestic commerce, sometimes even including a prohibition on private trade in rural areas. Extensive price controls led to the development of parallel markets, and the overall impact of these policies was to curtail drastically the development of a productive private sector. In order for these economies to be able to respond to opportunities provided by the external sector, the domestic markets need to become more competitive. Liberalization of the domestic product market should be implemented in conjunction with the depreciation of the real exchange rate in order to raise the profitability of traded goods.

Increasingly, the appropriate exchange rate for all transactions is considered to be the rate determined by the supply of and demand for foreign exchange in an auction - the so-called market-determined exchange rate. However, for a country that is receiving large inflows of balance-of-payments assistance, the market-determined exchange rate may still be overvalued and this may forestall the achievement of medium-term balance-of-payments equilibrium. The problem in such cases is that devaluation usually has been resisted for long enough that the premium on the parallel market has increased. Even Governments that are strongly committed to reform are reluctant to quickly close the gap between the official exchange rate and the rate on the parallel market and to establish an exchange rate system that will maintain a competitive real exchange rate. Without domestic financial stability, which mainly requires budgetary discipline, a market-determined exchange rate system may be unsustainable. For example, large fiscal deficits may cause huge depreciation of the exchange rate, which the Government may consider unacceptable (Sakala and Ndulo, 1988). Even when budget deficits have not increased, perceived political instability may lead to an increase in capital flight, which can cause a large nominal depreciation that is likely to invite government intervention in the operation of the market, including the introduction

of foreign exchange controls. A managed foreign exchange system that includes an adequate initial devaluation to establish competitiveness, followed by a crawling peg to maintain competitiveness is more appropriate for Africa than a market-determined exchange rate system. This is true in part because if the supply of foreign exchange to the auction in a market-determined system comes from foreign aid, the system is unlikely to be sustainable when aid is reduced or suspended.

*2. Liberalization of international trade*

Domestic market liberalization and real exchange rate depreciation should be undertaken before liberalization of international trade. Across-the-board liberalization of consumer imports can be particularly harmful to the domestic economy and to the balance of payments. Liberalization without real depreciation increases imports that out-compete domestic production and lead to a rapid exhaustion of foreign exchange reserves. Exports take longer to respond to domestic liberalization and to a depreciation of the real exchange rate than do imports. If countries are not willing to depreciate their currencies, it is irresponsible for them to liberalize imports. For example, the CFA countries should not have extensively opened their import regime before they had resolved the overvaluation problem. The worsening balance-of-payments positions and increasing external indebtedness of countries such as Côte d'Ivoire and Senegal is partly explained by premature trade liberalization, undertaken before the necessary exchange rate adjustment was achieved (Devarajan and de Melo, 1987).

Trade liberalization itself needs to be appropriately sequenced. The removal and tariffication of non-tariff barriers should largely be confined to intermediate inputs and capital goods. There is no need to remove restrictions on all imports, particularly where it is possible to promote domestic competition and expand exports of first-stage import-substituting consumer goods such as cotton textiles, shoes and footwear, and simple domestic utensils.

Trade liberalization must be undertaken in a manner appropriate for the situation of each country. For countries that have a significant industrial base, such as Kenya, Zimbabwe and Côte d'Ivoire, across-the-board liberalization of consumer imports can lead to unnecessary de-industrialization (Riddell, 1993). However, in countries where the manufacturing sector has collapsed because of severe foreign exchange shortages, such as Tanzania and Ghana, liberalizing of consumer imports was necessary to improve incentives. For these countries, moderate and uniform tariffs that are effectively collected is the appropriate policy. High and widely dispersed tariffs with many exemptions neither provide adequate tax revenue nor promote sustainable industrial development.

The removal of quantitative restrictions and the reduction of tariffs on intermediate imports and capital goods will make it possible to increase domestic production of tradables, including export goods. Elimination of quantitative restrictions on consumer goods that can be produced domestically should be carried out only after the balance-of-payments position of the country has improved. Successful East Asian countries such as the Republic of Korea and Taiwan Province of China do not import consumer goods that are domestically produced from cheaper sources such as Thailand and Bangladesh. Development-oriented import liberalization should be producer-oriented rather than consumer-oriented.[10]

*3. Liberalization of domestic financial markets*

The fast-growing economies of Asia, such as Taiwan Province of China and the Republic of Korea, have typically been characterized by a high degree of directed credit. In fact, government intervention in directing credit, including state ownership of banks and other financial institutions, has been common in many countries. More important than liberalization of financial markets, where interest rates and credit allocation are largely determined by the availability of loanable funds and the demand for credit, is the existence of an institutional framework capable of mobilizing savings and channelling them to investment opportunities that have high social returns. What is required to promote development is financial stability in the form of moderate or

low and stable inflation and solvent financial institutions capable of effective intermediation. With low inflation rates, it is possible to maintain slightly positive real interest rates, which are preferable to high real interest rates. High interest rates may be a disincentive to savings because the income effect of such high rates encourages consumption. In addition, more enterprises that borrow at high interest rates may be unable to repay their loans, which may lead to financial collapse (Diaz-Alejandro, 1985).

The problem of financial systems in Africa is that a large share of directed credit has been channelled to perennially loss-making firms, mainly parastatel enterprises and agricultural marketing institutions. The problem has been worsened by a premature increase in nominal interest rates. A prerequisite to successful financial-sector reform in Africa is the commercialization of public-sector enterprises, including the introduction of multiple-channel agricultural marketing systems. Unless enterprises in the real economy are operating on a commercial basis, the financial sector cannot be liberalized without triggering a worse financial and economic crisis.

Another path to financial crisis would be to allow the proliferation of commercial banks and other financial institutions with increased reliance on bank supervision in the Central bank. Countries that are dominated by state-owned commercial banks should avoid prematurely opening up to foreign commercial banks; the state-owned banks must be restructured and must start operating commercially first. A premature opening to foreign commercial banks may accelerate the collapse of domestic banks if foreign banks take over the most profitable business - for example, in the key commercial centres of the country - and large depositors transfer their deposits from local banks to the more efficient foreign banks.

African countries need development banks that will channel credit to smallholder agricultural producers and to small and medium-scale enterprises, which are likely to be unable to get credit from profit-maximizing and risk-averse private foreign and local banks. The disappointing results of development banks in Africa, namely their low rates of loan recovery, and the lack of success of similar World Bank projects should not be used as an excuse to end the search for a workable institutional set-up for development banks. The process by which successful development occurs is characterized by "a lot of bumbling and stumbling and going back and forth" (Bruton, 1993). What is important - and what has so far been lacking in Africa - is the ability to learn quickly from past mistakes and to adjust and reform institutions so that they attain their objectives.

### 4. *External financial liberalization*

African countries do not have vibrant capital markets, and the existing stock exchanges involve only a few companies. Nonetheless, emerging capital markets in developing countries have attracted international investors. In Africa, the Johannesburg bourse is the most active, but Zimbabwe, Kenya, Côte d'Ivoire, Nigeria, and Ghana are interested in expanding trading in their markets (*The Economist*, 1994). Other countries in Africa also are seeking technical assistance to introduce stock exchanges. The positive impact on investment of introducing capital markets should not be exaggerated. Even in developed countries, capital markets are not a major source of financing for new investment. As Stiglitz (1994) has noted, the capital market "is perhaps more a gambling casino than a venue in which funds are being raised to finance new ventures and expand existing activities. Indeed new ventures typically must look elsewhere".

A prerequisite for the development of capital markets is a vibrant domestic economy. For Africa, the most important capital account liberalization measure is promotion of foreign direct investment to complement local investment. Productive foreign investment is likely to flow to those countries that provide an environment that is also conducive for domestic investment. To successfully promote private investment, both local and foreign, a country must have a good infrastructure, particularly in transport and telecommunications; dependable power and water

supply; macroeconomic stability in the form of moderate inflation and a competitive exchange rate; and easy access to foreign exchange for importing inputs and capital goods. Promoting foreign direct investment requires liberal rules that permit the repatriation of profits, even though foreign investors are likely to invest most of their earnings within the country. Special favours such as tax holidays to attract foreign investment are unwarranted. African countries should not expect large inflows of foreign direct investment, although even limited foreign investment can be useful if it results in the introduction of new technology and management practices, training of local managers and technicians, and establishment of export marketing networks.

No African country has reached the level of development where free movement of capital out of the country should be allowed. However, political and economic instability has led to huge outflows in the form of capital flight. The appropriate policy response to capital flight is not to legalize capital outflow, but to make domestic investment more attractive. Adjusting overvalued exchange rates and providing a legal framework that sets clear rules on property rights and thereby promotes investment is more important for reducing capital flight than any government controls on foreign exchange.

### B. *Inappropriate sequencing of structural adjustment reforms*

There is no evidence that structural adjustment programmes sponsored by the IMF and the World Bank have actually followed such a logical sequence. Recently the World Bank has recognized a logical sequence of (1) realigning relative prices and improving the functioning of product and factor markets, (2) restoring financial balance and restructuring the financial system, and (3) instituting reforms that will create an enabling environment for private-sector expansion. *Adjustment in Africa* goes on to stress the importance of sequencing reforms by first implementing policies that will free up administrative capacity within the Government, such as exchange rate adjustment and removal of price controls, and only later implementing reforms that use additional governmental capacity. In practice, however, it is argued that:

> Given the close relationship between import liberalization, public enterprise reform, government finance, and financial sector reforms, this whole set of reforms should be attempted simultaneously and consistently ... Fixing only one of these distortions at a time is likely to be of little value (Husain and Faruqee, 1994, pp. 435-436).

This recommendation appears to ignore all the arguments for economizing on the use of the limited technical and administrative capacity of African Governments and instead appears to favour overloading the Governments' administrative machinery with reforms.

For the most part, African Governments have not had a comprehensive reform agenda of their own and have tended to react to proposals from the World Bank and other aid agencies. Strong opposition within many countries to exchange-rate devaluation and to the liberalization of agricultural markets has precluded following an appropriate sequence for reforms. Some African countries have been requested by the World Bank and the IMF to liberalize imports even when they had refused to adjust their exchange rates. In Tanzania, nominal interest rates have been increased without commercializing the activity of major borrowers, which led to large increases in bad loans. The banking sector was opened up before the supervisory capacity of the central banks had been strengthened and before domestic banks had been reformed.

### C. *Creating a sense of ownership*

The lack of success of African countries in implementing economic reforms, in general, and structural adjustment programmes, in particular, is partly explained by lack of domestic ownership of the programmes. The sentiment that adjustment policies have been imposed on the countries by the World Bank and the IMF is shared by

government officials, intellectuals, and the population of these countries at large. The sequence of events is generally as follows: the IMF drafts its letter of intent, to be signed by the country's Minister of Finance, stipulating the financial and budgetary policies that the Government should implement. The World Bank and the IMF draft a policy framework paper, which is not usually widely discussed within African Governments. In drafting these letters of intent and policy framework papers, the staff of the World Bank and the IMF are usually more interested in having the documents accepted by their own Boards than in ensuring that they accurately reflect economic and institutional realities in the countries concerned. Policies and programmes tend to be similar from one country to another in part because a programme that resembles one which was successful elsewhere is more likely to be accepted by the IMF and the World Bank management. Local policy-makers may not be aware of the larger IMF and World Bank policy agenda when they start implementing reforms. For example, by accepting a World Bank-sponsored study of public enterprises, countries may be tacitly approving a policy of privatization that they will later be required to implement. Local participation in such studies, which are supposed to be joint efforts between the Government and the World Bank, is usually minimal and cosmetic; the reports are usually written by the Bank staff or Bank-appointed consultants. The policy recommendations usually reflect the current policy fads within the Bank. In the end, the policy packages imposed on African Governments have tended to be without local advocates who can articulate their relevance or develop implementation plans appropriate to the conditions in the country in question.

Inadequate technical and administrative capability and inappropriate incentive structures within African Governments partly contribute to the lack of domestic ownership. The major cause is, however, policy conditionality attached to the provision of external finance. The IMF and the World Bank are perceived as offering such financing on a take-it-or-leave-it basis: countries that do not reach an agreement with the IMF and the World Bank will not receive external financing. As a result, policy conditions may be accepted under duress, but then not effectively implemented.

A more appropriate procedure would be for African Governments to present an adjustment programme and reform agenda themselves and to engage in a serious dialogue with multilateral and bilateral donors about how to finance their own adjustment effort. Technical assistance in designing adjustment programmes could be provided not only by the World Bank and the IMF, but also by independent research institutions. The most important factor is for Governments to determine their own policy agenda.

The process of policy formulation and dialogue between the World Bank and member countries is also problematic. World Bank offices in member countries are quite small and have only limited powers to make decisions. Most work is done by the Bank's numerous missions and consultants, without adequate coordination among these many actors. In many cases, member countries are not well prepared to receive these missions and the long reports such missions prepare are hardly read or digested. The sometimes rapid turnover of staff in a particular country further undermines the communication channels that have been established between the World Bank and member countries. Strengthening and empowering local World Bank offices in African countries is a long overdue reform. Such measures may offer the Bank some savings in its operating expenses by drastically reducing the need for short-term missions and allowing the local offices to work with the Governments and with less expensive local consultants.

### *D. World Bank/IMF coordination*

The balance-of-payments and external debt problems facing African countries are long-term issues that can only be resolved by debt cancellation and rapid and sustained economic growth. The division of work between the IMF and the World Bank in addressing the long-term

balance of payments problems of the African countries is not clear. Although the IMF is not providing any significant resources, it is in the forefront in designing stabilization programmes. There still is inadequate coordination between the two institutions, with each organization often sending a separate mission.

Financial-sector reforms, privatization and civil service reform have both short- and long-term macroeconomic implications. Balance-of-payments support from the IMF is supposed to be in the form of short-term lending of revolving funds. Even after the introduction of SAF and ESAF, the IMF does not provide development finance to promote the export sector and efficient import substitution. Since 1984, sub-Saharan Africa recorded negative net inflows from the IMF. Moreover, the standard IMF programme and performance criteria (including the quarterly credit ceiling) are particularly irrelevant in monitoring far-reaching structural and institutional reforms that involve not only exchange rate adjustment and trade liberalization but also privatization, fiscal and civil service reforms, and financial-sector reforms. Finally, the prerequisite of having a Fund programme in order to qualify for structural adjustment borrowing from the Bank and for debt rescheduling from the Paris Club effectively gives the IMF veto power over the reform programmes of the countries concerned without giving it the responsibility to negotiate and to fund the medium- and long-term institutional reforms that are necessary to create an enabling environment for economic growth.

Structural adjustment lending emphasizes policy reforms and provides quick-disbursing balance-of-payments support. Although the World Bank has continued to finance some investment projects in conjunction with other donors, such as rehabilitation of roads, the strategy planning of African countries has not included the kind of broad assessment of the investment requirements in physical and social infrastructure that would most effectively support private-sector investment and production. The key policymakers in the planning and finance ministries are overwhelmed by the tasks of negotiating structural adjustment programmes and debt rescheduling, and they have been unable to develop a medium- and long-term development vision or to explore the implications of such a vision for investment requirements.

## Conclusions

The task of improving economic policy-making and the implementation of reforms can only be undertaken by African Governments themselves, through the conscious decisions they make to improve the efficiency of public administration. The basic principle of maintaining macroeconomic stability is not technically complicated - it essentially involves limiting the overall budget deficit to a level sustainable through available external finance and non-inflationary borrowing from the banking system. Managing an exchange rate system is not difficult when budget deficits and inflation are under control. After an adequate initial devaluation, which should lead to a slight undervaluation of the domestic currency, a crawling peg can be used to maintain a competitive exchange rate.

The main challenge facing African Governments is to reform their tax systems by improving tax administration and imposing efficient taxes and to set priorities in government spending so as to support long-term growth. These are both technical and political problems. African government bureaucracies have to be restructured to support rather than supplant private-sector investment and production.

The international community can assist African countries by across-the-board debt cancellation of past debt to offer an opportunity for each country to initiate sustainable growth. Additional development assistance, mainly in the form of grants, should be offered conditional upon the existence of a serious and coherent development programme. The existing practices of debt relief, including the "enhanced Toronto terms", have not provided adequate relief to eliminate the debt overhang problem. To insist that debt relief be provided only to countries that have a stabilization programme with the IMF is to

promote reform programmes that are viewed as externally imposed and lacking in local advocates, and thus to reduce the prospect for their effective implementation.

## *Notes*

1 The countries are Bangladesh, Bolivia, Burundi, Gambia, Ghana, Guinea, Guyana, Kenya, Lesotho, Madagascar, Malawi, Mauritania, Mozambique, Niger, Senegal, Sri Lanka, Tanzania, Togo, and Uganda.

2 Including Benin, Burkina Faso, Burundi, Cameroon, Central African Republic, Chad, Congo, Côte d'Ivoire, Gabon, Gambia, Ghana, Guinea, Guinea Bissau, Kenya, Madagascar, Malawi, Mali, Mauritania, Mozambique, Niger, Nigeria, Rwanda, Senegal, Sierra Leone, Tanzania, Togo, Uganda, Zambia, and Zimbabwe.

3 There are at least 73 countries eligible for SAF and ESAF. In principle, all countries that are eligible to borrow from IDA can access SAF and ESAF. In practice, China and India have decided not to borrow from SAF and ESAF so as to allow small low-income countries to have greater access.

4 Bangladesh, Malawi and Senegal had an improvement in the terms of trade while Uganda and Madagascar had an annual decline in the terms of trade exceeding 10 per cent.

5 The *IMF Staff Papers* have provided leading insights into how to evaluate Fund-supported programmes. See, for example, Khan (1990).

6 In measuring the primary current account deficit, current payment excludes interest payments and amortization of the public debt.

7 In its earlier report, the Bank dismissed external factors as irrelevant to the causes of Africa's economic crisis which led to an acrimonious debate with the United Nations Economic Commission for Africa.

8 Helleiner (1994) has called for a formal end to the decade of structural adjustment in sub-Saharan Africa because of the existing confusion between structural adjustment and long-term development.

9 Moreover, the behaviour of commodity prices during 1960-1977 was used to dismiss the Prebisch-Singer thesis that the secular tendency of the terms of trade of primary commodities is to decline.

10 For a discussion of a producer-oriented trade policy, see Scott (1992).

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# THE EAST ASIAN MIRACLE: WHY THE CONTROVERSY CONTINUES

**Robert Wade**


### *Abstract*

*In September 1993, the World Bank published a study under the title "The East Asian Miracle: Economic Growth and Public Policy", which had been initiated and financed by the Japanese Government. Throughout the 1980s, the World Bank had been emphasizing the importance of an "enabling environment" for private sector growth, to be secured by "market-friendly" policies. Japanese aid programmes, on the other hand, had been based on more interventionist principles with considerable scope for selective industrial policies.*

*By and large, the World Bank sees its approach confirmed by the study; it concludes that the experience of the fast growing East and South-East Asian economies was primarily due to "market-friendly" policies and that selective industrial policies have been largely ineffective. But it also finds that the policy of export incentives was successful and that targeted, concessional credit may have been effective in some cases.*

*The Bank is right to emphasize the dangers of selective industrial policy, but the* East Asian Miracle *would have done a service by examining in detail how East Asian countries integrated protection, export promotion, and industrial, technology and education policies. Distinct from what the World Bank assures, selective industrial policy can be done on a small scale and in an incremental way. It may be part of a wider strategy to tame the socially destructive effects of free markets and may contribute to nation building.*

*Overall, the World Bank study's evidence for the proposition that selective industrial policies were ineffective is quite weak. The report makes a variety of theoretical and empirical assumptions that bias the results against such policies. However, it has given the issue more serious attention than any other World Bank publication in the past decade, and its arguments can be taken as an agenda for further research.*


## I. Introduction

In early 1992 the World Bank initiated work on a special project to examine the experience of the fast-growing East and South-East Asian economies, and to suggest lessons for developing countries elsewhere. That the Bank had not attempted such an overview study well before this time is itself remarkable, given that this region has for many years been the site of the biggest success stories of the post-war era. In the event, the study was done at the urging of the Japanese Government, which also, not incidentally, agreed to provide the whole cost (other than the cost of World Bank staff). Without the Japanese initiative and funding, the study would probably not have been made.

Some eighteen months later, in late September 1993 - in time for the Annual Meeting of the World Bank and IMF - the study was published under the title "The East Asian Miracle: Economic Growth and Public Policy".

Much was at stake. Through the 1980s the Bank had been pressing the view that the central problem of developing countries was the weakness of their "enabling environment" for private sector growth, where the enabling environment consists of infrastructure, a framework of law and property rights, macroeconomic stability, transparency of policy-making, and primary education. Policies to secure such an environment are called "market-friendly".

The Japanese Government, on the other hand, had been basing its aid programmes on a more interventionist set of principles that sanctioned attempts to prioritize activities, in order to give more help to some industries than to others, with the set of targeted industries changing over time. And it claimed that the potential benefits of this approach in developing countries today are illustrated by the actual benefits from the selective industrial policies of pre- and post-war Japan, and more recently, of Taiwan Province of China and the Republic of Korea. And since the Japanese Government has become not only the biggest source of bilateral aid funds in the world, but also the second biggest shareholder in the World Bank (1984) and (equal with Germany) the IMF (1992), its views can no longer be ignored by those who are opposed to them.

The study on the "East Asian Miracle" concludes, in the words of President Lewis Preston's preface, that "rapid growth in each economy was primarily due to the application of a set of common, market-friendly economic policies" (p.vi), that in turn created a stronger enabling environment for private sector growth. Conversely, *selective* industrial policies - designed to promote growth in particular industries - turn out to have been largely ineffective. This is fortunate for the Bank, for if the study had found that selective industrial policies had been effective in the northern tier East Asian countries, this would have posed a serious challenge to the legitimacy of the Bank's role as intellectual leader of the development debate, seeming to undercut what it had been insistently telling the world for the past decade. But the study does also come to some conclusions that are more consistent with the Japanese view. It finds that policies designed to give positive net incentives for *exports* have been effective, although such policies go beyond the principle of "undistorted", "level playing field" prices. It also finds that targeted, concessional credit *may* have been effective in early post-war Japan, and perhaps even in the Republic of Korea. And it draws the methodological conclusions that, again in Lewis Preston's words, "... economic policies and policy advice must be country-specific if they are to be effective", and that "the institutional context within which policies are implemented is as important to their success or failure as the policies themselves". Neither of these methodological conclusions have received this much emphasis in earlier Bank statements of lending principles, and both are in line with Japanese views.

Yet on the question of whether selective industrial policies were effective in North-East Asia, the Bank comes out with a fairly clear no. The relevance to other developing countries is clear: if selective industrial policies were ineffective in the countries that are widely regarded as the industrial policy champions, then *a fortiori* they are unlikely to be effective elsewhere. With some qualifications at the margins, the Governments of developing countries should stick to "market-friendly" policies designed to create a better enabling environment for private sector development. This sets the question: how good is the evidence for the proposition that selective industrial policies were ineffective in North-East Asia? How much confidence can we have in it?

The report adduces at least four kinds of evidence. The first concerns industrial structure; the second concerns productivity growth; the third concerns the Republic of Korea's heavy and chemical industry (HCI) drive; the fourth has to do with the fast growth of the South-East Asian countries without much "intervention". I assess these in turn.[1]

My conclusion is that the report's body of evidence is quite weak, and leaves open the argument that selective industrial policies *can* (not will) be effective in raising rates of overall economic growth and welfare.

## II. The industrial structure argument

The World Bank report compares the manufacturing structures of Japan and Korea against Chenery-Syrquin norms, which show the shares of GDP originating in various manufacturing sectors across a cross section of countries (normalized for population size and per capital income). The conclusion: there is not much difference between the actual structures of those two countries and what the Chenery-Syrquin norms would predict (Chenery and Syrquin, 1975). The comparison is between a year in the 1960s and another in the late 1980s (table 6.15 of the report). This result suggests, says the report, that selective industrial policy aimed at changing the composition of industrial activity did not work, in the sense that it did not make a difference from what would have happened anyway as a result of free market forces operating with reference to factor intensities and changing relative factor prices. In the words of the report:

> In Korea ... despite the government's extensive efforts to speed the private sector's shift from labour-intensive to capital- and technology-intensive industries, the relatively labour-intensive [and non-promoted] textiles and garments sector was nearly three times bigger than international norms predicted in 1988 .... During the same period, Korea merely maintained the international norm in chemicals, a heavily promoted sector; while other heavily promoted sectors, basic metals and metal products and machinery, achieved only modest improvements [relative to the norms] (pp. 312-313).

What is wrong with this argument? First, Chenery-Syrquin norms are based on averages across many countries, including such "interventionist" ones as India, Brazil and Argentina. Therefore it is a *non sequitur* to say that they show what structural changes a "normal" economy would experience in response only to free market forces - that is, in the absence of selective industrial policies.

Second, it begs two questions to say that, as their per capita incomes rose, the East Asian countries would have experienced the same structural changes without selective promotion policies. The first begged question is whether per capita income would have risen at the same speed without the selective promotion policies. The second is whether they would have been able to expand in the promoted sectors as much as they did (thus matching the Chenery-Syrquin norms) without deliberate promotion. The report simply assumes that the answer to both questions is yes. It assumes, in other words, that a free market - perhaps boosted by "functional" (and non-sector-specific) industrial policies, such as assistance to small enterprises and to exporters - will allow poor countries to achieve an "advanced" industrial structure in a few decades.

Proponents of selective industrial policy question these assumptions. Among other grounds for scepticism, they point to increasing returns, whether due to (static) economies of scale or to (dynamic) economies of learning-by-doing, and to benefits from new activities for which the initiators are undercompensated relative to the gain to the wider economy (so-called spillover benefits or externalities). Increasing returns and externalities cause investment in the industry to be inadequate relative to the potential social returns if the investment decisions are left entirely to private entrepreneurs and real-world private financial institutions.

The industrial policy advocates also make a powerful historical point: During the past two centuries there have been few examples of countries other than microstates achieving an advanced industrial structure without selective industrial policies.

Finally, there are certain general patterns of final demand growth and technological change (or increasing linkages in an input-output table) that occur widely among middle-income countries. For example, agriculture regularly becomes more dependent on industrial products. (These are the sorts of regularities that the Chenery-Syrquin norms capture.) Likewise, there are regularities in the extent to which different industries have (static) increasing returns to scale and (dynamic) economies of learning. The fact of these

regularities *may* mean that a laissez-faire economy will move through a sequence of changes similar to that of another whose Government is more dirigiste (provided the more dirigiste one is still fairly open to international competitive pressures - as the Democratic People's Republic of Korea is not, but as capitalist economies with managed trade such as Japan, the Republic of Korea and Taiwan Province of China have been).

The question, however, is how quickly the changes in industrial structure will occur in each country. Precisely because of these cross-national regularities in changes in final demand and technology, it is not difficult for well-informed Government officials to identify which families of industries will next have fast demand growth and productivity growth, and which ones will have increasing (static or dynamic) returns. (Remember that we are talking of middle-income countries, not countries whose firms are on the world technology frontier.) Consequently, it is not difficult for these well-informed officials - if they are also well-intentioned - to target promotional help to accelerate entry into these sectors and ease the exit from sectors with slowly growing final demand, low technological change, and diminishing rather than increasing returns. A Government that refuses to try to promote such industries is likely to find its own entrepreneurs excluded from them, and foreign entrepreneurs in the form of multinational corporations attracted elsewhere - to countries whose Governments do make targeted incentives available. Given the cumulative nature of technological learning, failure to promote these industries is likely to put the economy on a lower growth trajectory than otherwise.

## III. The total factor productivity argument

The report's second major argument is based on a comparison of total factor productivity (TFP) growth in promoted industrial sectors against TFP growth in non-promoted sectors, where sectors are defined according to Standard International Trade Classification (SITC) categories at the two-digit level that is, relatively broadly. The basic finding is that, for the Republic of Korea and Taiwan Province of China, there is either no significant difference between the TFP growth rates of promoted and non-promoted sectors, or TFP growth was actually lower in promoted industries; for Japan, TFP growth was higher in promoted industries. The report's overall conclusion is that "the evidence that industrial policy systematically promoted sectors with high productivity change is weak" (p. 316). The report further concludes that:

> ... attempts to determine whether high rates of TFP growth combined with rapid growth of promoted sectors can plausibly explain the very high overall rates of TFP change in manufacturing yield mostly negative results ... The main reasons for manufacturing's success in Japan, Korea and Taiwan ... lay in the high general rates of TFP growth, including those in labour-intensive, non-promoted sectors (p. 316).

Whereas the comparison with Chenery-Syrquin norms involves a *non sequitur*, the comparison of TFP growth in promoted versus non-promoted sectors proves nothing. There are at least six different problems with the TFP calculations.

*(1) The problem of the irrelevant comparator*

The standard test of infant-industry promotion involves comparing the performance of the promoted industry in country X against the performance of the same industry in the rest of the world, not performance of the promoted industry against that of non-promoted industries in X.

*(2) The problem of the TFP methodology*

TFP is calculated as a residual. Slow-growing economies automatically have low TFP growth rates - but low TFP growth rates hardly explain the slow grow. In fast-growing economies (like those in East Asia), one would expect all sectors, whether promoted or not, to have large residuals - to have high TFP growth. Therefore the fact that there is not much difference in the size of the residuals between promoted and non-promoted sectors cannot be given much explanatory significance.

More generally, the measurement of TFP depends critically on assumptions about production functions, the choice of output (value-added versus gross output), the use of capital stock versus flows of capital services, the quality of inputs, cyclical smoothing, the time period studied, and so on. Different assumption yield radically different results. The Bank's TFP test is based on a Cobb-Douglas production function, which assumes a fairly large degree of substitutability of labour and capital (implying relatively efficient markets) and constant returns to scale. However, a study by Park and Kwon (1993), using a non-Cobb-Douglas production function incorporating an assumption of imperfect markets and non-constant returns to scale, finds TFP growth to have been negative.[2] Even within the set of studies that use a Cobb-Douglas function the World Bank's estimate of TFP growth for manufacturing in Korea (8.8 per cent per year) is roughly twice as high as those from most others.

Given all the uncertainties about TFP, one should at least combine its use with other indicators of performance, such as export success.

*(3) The problem of externalities*

The report justifies the use of two-digit SITC sectors as the unit of analysis partly on the grounds that positive externalities spilling over from promoted to non-promoted sectors will be largely contained within the broader two-digit sector. Therefore, if externalities are important, they should show up at the two-digit level in the form of rapid growth of promoted sectors (that is, more rapid growth in those two-digit sectors that contain a large number of promoted sub-sectors than in those that do not). So, according to the report, it cannot be argued that an important part of the benefits of selective promotion are missed by examining only the specifically targeted sub-sectors.

What is the evidence for this crucial proposition? The report cites only one study, which examines the pattern of spillovers of research and development (R&D) in industrial economies. That study suggests that the major beneficiaries of R&D spillovers in industrial economies are closely related sectors, and often those in the same two-digit classification as the sector undertaking the R&D (see p. 324 of the report). But so what? Another important form of spillovers (which some have called "slurpovers") is more general "learning" of technological mastery, which seems to be particularly important between the users of machinery and the producers of machinery (between textiles and textile machinery, automobiles and machine tools, and chemicals and plant engineering). Raw materials and chemical processing are another linked pair. Many of these pairs cross two-digit industry categories.

Two-digit sectors are much too large for the impact of selective industrial policies to be gauged. Certainly the North-East Asian policy-makers did not target such large aggregates. This being said, however, the inadequacies of the report's treatment of externalities do highlight our severe knowledge gap on the crucial question of where external benefits fall. Without better empirical knowledge, unmeasured externalities are too easily the last refuge of industrial policy advocates.

*(4) The problem of interaction effects*

If the TFP methodology is likely to miss important external benefits of selective promotion, it is also likely to miss other benefits by not examining the effects of selective industrial promotion on exports and the role of these policies in modest financial repression.

The report places central importance on the East Asian policy emphasis on exports. But it identifies the content of this emphasis only in terms of policies focused directly and generically on exports (from whatever sector). Surprisingly, it fails to consider (both in the TFP test and in the rest of the report) the impact of selective industrial policies in helping the targeted firms and industries enter export markets, and it underplays causation in the opposite direction - from exports to the disciplining of selective industrial policies.

The report also acknowledges that "modest" financial repression may have helped growth. But it fails to acknowledge that selective industrial policies, as part of a general accumulation strategy, themselves helped to mobilize resources (not just to allocate them) and were an integral part of modest financial repression. In other words, the effectiveness of modest financial repression and other credit market interventions in North-East Asia may have been linked to the way those interventions were integrated with protection, technological promotion, and the like.

*(5) The problem of the time period*

The case of the Republic of Korea illustrates that the choice of time period can be critical to the outcome of the analysis. The World Bank report presents data on long-term TFP growth in various Korean industries for a period that is not explicitly stated but can be presumed to be from about 1965 to 1985 (table 6.16 of the report). The problem is that many of the promoted industries were not promoted until the mid-1970s (for example, semiconductors, shipbuilding, and steel). And by 1985 many were still recovering from the severe recession of the early 1980s, showing much better performance after 1985. If the period had been, for instance, 1975 to 1990, the performance of the promoted industries would have looked substantially better.

*(6) The problem with textiles*

The report makes much of the fast growth of the Korean textiles industry, its rising share of manufacturing value-added, and rapid TFP growth in this sector, which it identifies as "non-promoted". This industry's excellent performance despite its being treated with "benign neglect" seems a powerful point for non-intervention. There are just two small problems.

First, the claim that textiles was not a selectively promoted industry in the Republic of Korea is false. Textiles was, in fact, one of the most heavily promoted industries, mainly because of its foreign-exchange-earning capacity. For example, a major promotional package was put in place for textiles in 1979, and again in 1986 (so we encounter the time period problem again; see Chang, 1993b, table 4). This was, of course, a different kind of promotion from that in the steel sector, for example, but it was promotion and rationalization nonetheless. In no sense was the sector treated with benign neglect. Taiwan Province of China also gave intensive and selective promotional help to parts of textiles in several periods from the early 1950s through to the 1980s (Wade, 1990, chapter 4).

Second, textiles and clothing's share of value-added in the Republic of Korea did rise over the 1970s, but over the longer period it fell sharply from 20 per cent in 1963 to 14 per cent in 1989 (Kwon, 1993 table 2). The 1970s were a blip. Indeed, some of the help to the industry was designed to let parts of it down gently.

It is not clear what one should conclude from this evidence. But it is clear that one cannot say, with the report, that Korean textiles was not promoted and performed very well, and therefore one cannot use this sector to support the argument about the ineffectiveness of selective promotion.

## IV. The Republic of Korea's heavy and chemical industries drive

The World Bank report cites the Republic of Korea's HCI drive as a case of intensive selective promotion gone wrong. The evidence? The HCI drive had very high costs: direct financial costs in the form of subsidies, and indirect costs in the form of bad loans written off. And these promoted industries had lower rates of TFP growth than did light industries. However, the relevant criterion in evaluating the impact of the HCI drive is costs against benefits, not just costs. The report is strangely silent about benefits (see box 6.3 of the report), which is a bit like assessing a pair of scissors by examining only one of the blades. The Republic of Korea's heavy industries grew at an average of 17 per cent a year in 1979-1988. In the same period Brazil's grew at 0.6 per cent, Mexico's at 2.7 per cent, Spain's at 2.1 per

cent, and Greece's at - 0.8 per cent. Almost all parts of heavy industry showed dramatic improvements in their trade balances during this period (Chang, 1993b, p. 135; World Bank, 1992; Auty, 1994; Wade, 1990, chapter 10). These indicators suggest, prima facie, that there were substantial benefits from the HCI drive, which should be set against the costs.

Moreover, about 60 per cent of the non-performing HCI loans were accounted for by the construction sector alone. According to Amsden and Euh (1990), the parlous financial condition of the construction industry reflects over-investment in the Middle East - by private firms on their own initiative. It cannot be blamed on dirigisme by government bureaucrats.

Finally, Park and Kwon's comparison of TFP growth in light industries with that in HCIs yields the opposite finding from the Bank's: that the HCIs had decisively faster TFP growth than the light industries, which is roughly the same as saying that the promoted industries had faster TFP growth than the non-promoted industries (Park and Kwon, 1993). Their conclusion holds whether one uses a standard method for calculating TFP or the non-standard type of production function described earlier. Interestingly, it also holds for the specific sectoral contrast on which the World Bank study puts a lot of weight: whereas the Bank study says that the promoted iron and steel industry had slow TFP growth, and the non-promoted textiles and clothing industry rapid TFP growth, Park and Kwon, studying the same time periods, find exactly the opposite for the same time periods.

## V. The South-East Asia argument

Malaysia, Thailand, and Indonesia - the southern tier of high-performing Asian economies - have enjoyed fast growth over the 1980s without much in the way of selective industrial policies, thanks to far-reaching liberalization during that decade. This seems to confirm that government efforts to go beyond measures to provide infrastructure and strengthen the market framework are not necessary for fast, catch-up growth.

Things are not so simple, however. The fast growth of the southern tier has probably been driven to an important extent by the industrial restructuring and fast growth of the northern tier, "probably" because there seems to be little quantitative evidence. But if one put into a growth regression a variable that captures the growth of other countries in the region, the intra-regional growth effect would probably show up as important. Given the World Bank study's general appetite for growth regressions, the inattention to regional "neighbourhood" effects is surprising. On the face of it, a strong neighbourhood effect would qualify a central argument of the study, namely, that factors internal to each country are the prime determinants of each country's growth rate. Insofar as growth stimuli from the northern-tier countries are important, and insofar as those stimuli have been concentrated on the southern-tier countries because of their geographical and cultural proximity, the internal factors are less important than the study suggests.

We do not know much about the causal relationships involved in this neighbourhood effect - to what extent it works through trade, through foreign investment, through imitation, or through overseas Chinese networks. But we do know that foreign direct investment has been a big part of the story, particularly since the massive currency realignments initiated by the Plaza Agreement in 1985. The southern-tier countries received a great wave of direct investment, first from Japan, then from Taiwan Province of China and the Republic Korea, as firms from the northern-tier, facing appreciating currencies and rising labour costs at home, and rising protection in their export markets, sought production sites abroad that offered lower costs and were not yet subject to import quotas abroad.

The results of this investment so far raise some doubts about the robustness of the southern-tier's future growth and about the replicability of its growth mechanism. To begin with, this foreign investment is heavily export oriented. Three-

quarters or more of the output of foreign manufacturing subsidiaries in the southern-tier economies is exported. To that extent these countries' overall growth does not depend on growth in the domestic economy. The foreign investment is also concentrated in a narrowish product range - consumer electronics and other "low-end" electrical and electronic manufacturing.

Moreover, the exports of these foreign subsidiaries account for a very large proportion of total manufactured exports. For example, over 90 per cent of Malaysia's exports of machinery, electrical appliances, and consumer electronics comes from foreign-owned plants (World Bank, 1989, p. 24).

The foreign subsidiaries rely heavily on imported inputs. They thus constitute export enclaves, with only weak backward or forward linkages to domestic firms. Local content requirements imposed by host Governments are being met in large part by inputs from other foreign-owned subsidiaries rather than from domestically owned firms. For example, the local content of consumer electronics goods produced by Japanese firms in Malaysia was only 30 per cent in 1988, and most of the local parts were produced by other Japanese firms in Malaysia. Malaysian-owned firms mostly supplied packing materials and simple pressed parts (Ishigami, 1991, pp. 25-26; see also Yawata and Mizuno, 1990). In automobiles the situation is even more extreme. From the standpoint of the domestic economy, this is "technologyless industrialization" (Yoshihara, 1988).

These tendencies are being reinforced by the development of complex regional hierarchies of production. Some Korean and Taiwanese firms that had been producing at home for Japanese firms on an OEM (original equipment manufacturing) basis have now established plants in the southern tier. They may continue to produce for Japanese firms on an OEM basis in the new plants, obtaining their capital equipment and their high-value-added components from Japan, while themselves supplying the management and lower-value-added components.

The industrialization of the southern tier is therefore vulnerable to the relocation decisions of multinational firms. Because they are only weakly integrated into the local economies, the agents of southern-tier industrialization are less retainable, more likely to move their operations to sites where labour is cheaper (for example, Indochina) as local costs rise. Given the previous points, this aborts the alternative response of upgrading technology in response to rising costs. The host economy's long-term growth potential is in question, since its ability to sustain continual rises in real wages (an indicator of development success) is diminished.[3]

In contrast with the northern-tier Governments, those of the southern tier not only have allowed a foreign direct investment free-for-all, but also have been doing much less to forge links between foreign and domestic firms. That is to say, they have been abiding more closely by World Bank principles. They have also been doing less to improve the economy's general level of technological capacity - they have invested less in higher education and in R&D facilities, for example. This comparison is admittedly impressionistic. No sustained comparison of industrialization policy between the North-East and South-East Asian countries appears to have yet been made. It is a matter of regret that the World Bank study says almost nothing about it.

The growth mechanism in the southern tier is critically dependent on Japan as the supplier of capital goods, high-value-added components, technology, and aid, and on the United States as the demander of first resort. Virtually all the high-performing East Asian countries run large trade deficits with Japan and large surpluses with the United States. Indeed, the United States takes more than twice as much of the Republic of Korea's and Thailand's manufactured exports as Japan does, and four to five times as much of Taiwan's and Malaysia's. It is striking how little of the production of Japanese manufacturing subsidiaries in the southern-tier is exported back to Japan: only 10 per cent of sales in 1989. These imbalances are driving the well-known trade tensions in the region. As the United States reduces its balance-of-payments deficit, will Japan

become a significantly larger absorber of manufactured goods from the region? On the answer to this question, much of the future growth of the region depends.

What is the relevance of all this to the World Bank study's conclusion about selective industrial promotion? The study suggests that it was liberalization in the South-East Asian cases that mattered, rather than anything to do with selective industrial policy. It further suggests that other countries could have enjoyed the benefits of fast growth had they, too, liberalized in the 1980s. The argument developed here suggests, in contrast, that the fast growth of South-East Asia in the 1980s is a reflex of industrial restructuring in North-East Asia (the response to which was facilitated by southern-tier liberalization of controls on inward direct investment). The fact that offshore went to South-East Asia rather than to Latin America or South Asia may be due less to the fact that South-East Asia had better "fundamentals" than other cheap labour sites (as the report would argue), and more to other, regionally specific factors. About these we know rather little, but they would certainly include overseas Chinese networks, similarities in business practices, and the advantages of geographical proximity (even today when the technology is available to shrink great distances).

Two important conclusions follow. First, to the extent this argument is correct, the replicability of the South-East Asian experience is put in question. Second, the dependence of that experience on foreign direct investment, and the failure to anchor foreign firms in the domestic economy through input-output linkages and a general expansion of technological capacities, means that the continuing transformation of South-East Asian industrialization into higher-value-added activities is also in question.

In a word, the South-East Asian experience of fast growth without selective industrial policies does not do much to dent the argument that selective industrial policies were important in North-East Asia, or the argument that would-be catch-up countries in other parts of the world, and in South-East Asia itself, should consider selective industrial policies to help the move into higher-value-added activities.

## VI. World Bank economics versus East Asian economics

Overall, one has to conclude that the World Bank study's evidence for the proposition that selective industrial policies were ineffective in North-East Asia is less than compelling. It also has to be said, however, that the evidence provided by the so-called "revisionists" about the effects of the industrial policies that they so lovingly describe is also less than compelling. It leaves them open to the quip that a revisionist is someone who thinks the plural of anecdote is evidence. In the end judgment must be made about the balance of plausibility.

Two reasons can be offered to explain why the mainstream judgement has favoured the view that East Asian success is due mainly to the fact that markets worked better there, with less government distortion. One reason is that the theoretical apparatus for the study of competitive markets is much better developed than that for analyzing state power, organizations, and imperfect competition. Another is that the neoclassical mainstream is inattentive to history. One can move the debate forward by developing theoretical rationales for what East Asian policy-makers actually did, and by setting the East Asian experience in a wider historical context.

The report's discussion is rooted in the Anglo-American debate over whether the Government can "pick winners". This concept, and the World Bank's TFP test itself, assume that winning sectors are identified by their profitability or productivity performance. Other characteristics, and in particular the links with other industries, are not central. If potato chip manufacturers have higher productivity growth rates and profits than semiconductor chip manufacturers, then potato chips are the winners. (Formally, one can factor in such considerations through the distinction between social and private profitability. But

"social" profitability does not capture the idea of families of interconnected industries.)

The East Asian concept is different. The task is not to pick winners, but to identify "key" industries. This concept stresses inter-industry links - an increasing density of input-output linkages within the domestic economy and positive spillovers from key industries to others.

This difference stems from a more fundamental difference between a "framework" approach to public policy for economic development and an "ingredients" approach (Yanagihara, 1993). In the World Bank framework approach, the attention is on correcting distortions in price signals, so that individual agents can make investment and innovation decisions that are as close to optimal as possible. There is no presumption that anyone, least of all the Government, can guess with any accuracy the structure of the economy that will result from these individual decisions. Indeed, an essential feature of a good framework is that no actor can exercise any perceptible influence on the structural outcome. (This has its roots in Adam Smith's one-eyed conviction that harmful effects occur whenever power is used to alter the "natural course of economic life".)

In the (East Asian) ingredients approach, the attention is very much on the tangible structure of the economy, defined as a set of industries and organizations already in place (the ingredients), and especially on the desirable future structure of the economy. Public policies and organizations are designed so as to achieve a vision of the economy's future structure.

The difference is seen most vividly when an industry is in trouble. According to the framework approach, the Government should remain indifferent about whether the industry disappears, moves offshore, pays lower wages, or upgrades its technology so that it can continue to compete at current wages. The only exceptions arise when national security considerations are involved and when competition is unfair. According to the ingredients approach, the Government would be abdicating an essential responsibility if it did not have a view on the importance of the industry in its vision of the economy's future, and did not take action to produce results in line with that view.

The ingredients approach thinks in terms of stages of industrialization. Japanese post-war industrialization, for example, is often divided into a first stage of export-oriented, labour-intensive, light industrialization (textiles, household appliances) from 1950 to the late 1960s; a second stage of export-oriented heavy and chemical industrialization (steel, shipbuilding, petrochemicals, synthetic fibres) from the mid-1960s to the early 1970s and the first oil shock; a third stage of export-oriented, assembly-based, skill- and R&D-intensive consumer durables and industrial machinery from the late 1960s to the late 1980s; and a fourth stage of home-market-oriented, flexible manufacturing from the early 1980s onward. Each stage was associated with certain kinds of public policies, and each encountered certain growth constraints which prompted the shift to the next stage. Each stage also generated characteristic forms of international trade, investment and aid (Ozawa, 1991).

Japanese officials and academics tend to assume that other economies in the region are travelling along the same basic path. Behind Japan come the second-tier followers, Taiwan Province of China and the Republic of Korea; behind them the third tier, Malaysia, Thailand, Indonesia; and behind them the fourth tier, China and perhaps the Philippines. Further, they tend to assume that East Asia is an interrelated economy, with industrial restructuring from one stage to another in the more advanced countries generating - through those characteristic forms of international trade, investment and aid - growth impulses directed toward the less advanced countries.

This, put simply, is the "flying geese" theory of East Asian development. As was suggested earlier, there is plenty that is wrong with such a mechanical notion. But it seems an improvement on the "marathon" metaphor of development that underlies neoclassical thinking, according to

which the relative position of each country is a function largely of its own internal resources, and in which all countries could, conceptually, all be equally wealthy (all run abreast). Like it or not, the flying geese approach is certainly shaping the Japanese Government's economic strategy in the region.

The content of public policy, in this view, is derived from what has to be done to prepare the way for the next stage of industrialization. Whereas the framework approach sees trade policy as the king of policies, not just one among many (because if the trade regime gives low or no protection, the Government has little scope to mess up the economy with other kinds of interventions), the ingredients approach sees trade policy as subordinate to a wider industrial strategy, with technology and education policies as king and queen (Wade, 1993). The decision about whether to protect an industry is made not with reference to a general belief that tariffs and import controls lower economic welfare and should be avoided in all but exceptional conditions, but with reference to how protection, as one form of assistance among others, might help to move the industry along its designated trajectory in the wider vision. It is assumed that protection and the other forms of assistance may be decisive only for some industries in some countries at some stages of their growth, not for all industries at all stages.

There is as yet not much theory behind the ingredients approach. Certainly what is called "strategic trade theory" is of little relevance to what the East Asian Governments did, as the World Bank has been at pains to point out.[4] But there are several kinds of "soft" strategic intervention theory that have been developed to some extent and that do seem highly relevant. They refer to rationales for government intervention to promote selected industries for (soft) strategic reasons - not to raise the immediate profitability of the targeted industries, but to confer external benefits on other industries and to improve the competitiveness of one's own industry vis-à-vis those competitors elsewhere. They start from the recognition that countries specialize in different industrial products less for reasons of relative factor endowments than for reasons of which country is first able to capture economies of scale and economies of learning in a given industry, and thereby (because of the resulting high entry costs) deter firms elsewhere from entering (see also Wade, 1990; Matthews and Ravenhill, 1993; Lall, 1994; Bell and Pavitt, 1993).

In the case of industries with increasing returns (due to economies of scale or learning), there is no theoretical presumption that free market forces will reach an equilibrium that is not only stable but also welfare maximizing. There is indeed no general presumption that non-intervention by Government will be more beneficial than selective promotion. Which of many possible stable equilibria is actually arrived at - which pattern of specialization - depends on exogenous factors, such as accidents of history and industrial policies.

And the pattern of industrial specialization at any one time tends to set the direction for future development, because much technological knowledge is specific in application ("tacit" rather than "codified") and cumulative or path-dependent in development. Under these conditions price signals cannot be relied on to produce investment and innovation decisions that are anything close to socially optimal. They may lead entrepreneurs to specialize in low-value-added activities that face slow-growing markets. The result may be to "lock in" to a permanently lower growth trajectory than could be achieved with the same static comparative advantage where extra resources are allocated, by fiscal decision or deliberately "distorted" prices, to technological learning. By exercising economy-wide foresight, Governments can foster the development of "leading" industries that "drive and mould economic progress across a broad front" (Nelson, 1984, p. 1) by generating externalities for a broad spectrum of other industries raising the future, path-dependent technological level of the economy.

This is the sort of theory that has to be developed in order to understand what the East Asian policy-makers actually did. It has to be

reinforced by wider historical analysis of industrialization.[5] We have been misled by Adam Smith's thundering against mercantilist policies, and by later economists who treated mercantilism as the economic equivalent of flat-earth theory. They have failed to see that England's economic and political superiority over France, Sweden, and even Holland resulted from the greater "coherence and rationality of [its] mercantilist economy" (Wilson 1969, p. 153) or that Western Europe's economic and political superiority over the rest of the world was established during the mercantilist era. Later, it was the Prussian mercantilist State that forged the economic and political unification of Germany, while non-mercantilist Poland fell apart. The Russian and Japanese States were guided by mercantilist ideas, while non-mercantilist China was brought to its knees. Indeed, in the typical case the Governments of today's advanced industrial countries took measures to favour certain actors and shut others out, and to protect new industries from established competitors elsewhere. We do not well understand just how necessary such actions were in each industry in each country. Sometimes protection was maintained for a short time, and sometimes it persisted for decades; sometimes persistent protection seems to have been necessary in order to master the technology (consider, for example, the Japanese automobile industry), and in other cases it may have persisted for too long, beyond the point of significant net learning benefits - although this is not to say that the bulk of the learning benefits could have been acquired with no protection at all.

These facts have not received the attention they deserve, partly because we still operate under a Smithian assumption that the unit of analysis is the individual, not the nation-state, and still foolishly confuse mercantilism à la Friedrich List with socialism. The mercantilism of Europe and East Asia is all about building "rich country, strong military", in the Meiji phrase (that is, a rich country *for* a strong military), or building an economy strong enough to provide the means to fend off external threats. Limiting international trade and granting special trading privileges were a way to foster national merchant classes, entrepreneurs, and new industries. These fostered entities in turn provided revenue to the state, allowing it to expand its military capabilities. To portray mercantilism merely as a system where vested interests pushed and pulled the state to advance their interests is seriously wrong.

This is not to suggest that all cases of economic development in Europe required a mercantilist period. Some states benefited from spillover growth stimuli from mercantilist growth centres nearby, as may be happening in South-East Asia today. But these appear to have been exceptions. Putting the experience of the European mercantilist states together with that of the North-East Asian developmental states of the post-war period, we have grounds for concluding that, exceptions like Hong Kong and Denmark aside, they show us, analytically, what is required for fast and sustained development to occur. In any case, the combination of the new formal economic theories plus the interpretive theories of historical industrializations is making the established paradigm increasingly unattractive, and providing the shaft on which a new one will crystallize.

## VII. The World Bank's stance on selective industrial policies: a modest conclusion

There is reason to worry whether the World Bank's refusal to countenance selective industrial policies for industries with relatively high entry barriers reflects an underlying unwillingness to help developing countries enter industries that are already well established in the West, especially when Western plants have excess capacity. Or, more exactly, the Bank's refusal to help these countries mount selective industrial policies targeted on high-entry-barrier sectors means that if these economies are to enter these sectors, it must be largely at the invitation of Western and Japanese multinationals, with the host country itself having relatively little bargaining power. Given the governance structure of the World Bank, it is not difficult to imagine why. This is

quite different from the way in which the North-East Asian countries got established in these sectors - by using intensive selective industrial policies to forge partnerships or technology agreements between domestic firms and foreign multinationals.

Of course the Bank is right to emphasize the dangers of selective industrial policy. But *The East Asian Miracle* would have done a service by examining in detail how East Asian countries integrated protection, export promotion, and industrial, technology and education policies. Some would say that it is just at this point, which the study rushes past with a few casual remarks, that the real lessons of East Asian public policy lie. Such a study would show that it is not the case, as much Bank thinking assumes, that selective industrial policy must either be done on a big scale or not at all.

Take a small example from Taiwan Province of China. The subsidiary of a multinational enterprise was producing a product for which it needed a certain chemical of a very high level of purity, above that reached by domestic chemical makers. It was therefore importing the needed supplies. At a certain point the official in the Industrial Development Bureau responsible for that part of the chemical sector concluded that, with a little help, one or more Taiwanese chemical companies could produce the chemical to the requisite level of purity. He contacted the importing company and some relevant Taiwanese companies to discuss the possibilities. He urged the importing company to enter into a long-term supply agreement with one or more of the Taiwanese companies and to provide them with technical help. The company declined. But it then began to find that its applications to import the chemical, which previously had been immediately approved (all imports to Taiwan Province of China, at least until the late 1980s, have had to have a license, even when automatically approved), began to be delayed, and the delays began to lengthen. Eventually the company did what the official wanted. and one more Taiwanese company was helped to upgrade its technology, thanks to the ability of the Government to use its control over imports as an instrument for strengthening the national economy (for further discussion see Wade, 1990, chap. 5).

This is a selective industrial policy of sorts, but it is a "low-powered" selectivity, a far cry from what is normally meant by "picking winners". It shows how selective industrial policy can be done in a small, incremental way. Governments with weak capacity can begin with selective industrial policy on a modest scale, not attempting to pick winners from a long menu, but identifying what activities already going on in the country seem to be doing well, analyzing what public policy could do (and stop doing) to foster those activities, and putting low-powered programmes in place. Indeed, quite a lot of Taiwanese industrial policy was little more than an attempt to nudge existing firms to upgrade their technology - both by functional or across-the-board measures and by actions focused on "strategic" (or key ) industries, as in the above case. Of course, Taiwan also used high-powered selective policies as well, when the aim was a big jump in technological capability. These included sequencing the development of new industries and limiting entry to scale-intensive industries, so as to achieve economies of scale of production capacity and cumulative technological learning, and establishing infrastructural R&D organizations for the targeted industries (Wade, 1990, chapters 4 to 6).

To do selective industrial policy well on the scale done in East Asia probably does require a strong, fairly authoritarian state[6] (but not necessarily a non-democratic one: Japan has had a democracy of sorts these past fifty years). But it can be done on a much smaller scale, by a smaller bureaucracy better able to be insulated from the pressure groups of a Western-style democracy or even the personalistic networks of a patrimonial-bureaucratic state. There is a learning effect in bureaucracy as surely as in industry. If Governments do not attempt to accelerate, even modestly, the acquisition of technological learning in important industries, they will not learn how to do so. If they do not learn to do so, their firms will be handicapped in entering these sectors. Those in the West who do not want to see new competitors in these industries - or at least new competitors not under the control of their own

multinationals - may applaud this outcome. The World Bank should not (see further Wade, 1990, chapter 11).

But industrial policy is not just about building new industries and managing the decline of old ones. It can also be part of a wider strategy to tame the socially destructive effects of free markets - to check the propensity of people operating in a free-market ethos to see free riding as perfectly fair, and so to erode the bonds of community, tradition, and authority. Industrial policy, in other words, can be a source of social order and discipline, a means of nation building. Neither in *The East Asian Miracle* nor any of its other work has the World Bank begun to address such issues. It simply assumes that full-scale marketization in the context of what it means by the "enabling environment" is fully compatible with social order. The mercantilists knew better.

In a word, *The East Asian Miracle* makes a variety of theoretical and empirical assumptions that bias the results against selective industrial policy. On the other hand, it has given the issue more serious, less rhetorical attention than any other Bank publication in the past decade, and its arguments can be taken as an agenda for further research.

## Notes

1 A veritable cottage industry has sprung up in assessments of *The East Asian Miracle*. The author has benefited from Chang (1993a); Shiratori (1993); Yanagihara (1993); Williamson (1993); Evans (1993); Kwon (1993); and the papers presented at a Symposium on the World Bank's 'East Asian Miracle' Report, to be published in *World Development*, by Lall (1994), Perkins (1994), and Amsden (1994). The author has also benefited from discussions with Lance Taylor, Devesh Kapur, Peter A. Petri, Manfred Bienefeld, Hans Singer, Howard Pack and Catherine Gwin.

2 Another problem is that the report cites a study by Dollar and Sokoloff (1990) that gives quite different rankings of industries by long-term TFP growth than the report itself does. Dollar and Sokoloff show slow TFP growth for textiles and fast TFP growth for petroleum, the opposite of the World Bank report's results.

3 This is a preliminary conclusion which needs to be confirmed by examining microeconomic evidence on re-investment behaviour - expansion of existing plants, labour force training, and so on - in host countries by already established firms.

4 Strategic trade theory shows how government action can shift rents from oligopolistic foreign to oligopolistic domestic firms, improving not only the profitability of domestic firms but also national welfare.

5 The following discussion draws on Gunnarson (1993). The author has also benefited from Senghaas (1985) and Brewer (1989).

6 Compare Wolf (1991) who says: "If the price of successful interventionism is authoritarianism, it is one that does not have to be paid ... What reforming countries need is democratic constitutions that allow [the market to work], not more interventionism".

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# THE FUNCTIONING OF INTERNATIONAL MARKETS FOR PRIMARY COMMODITIES: KEY POLICY ISSUES FOR DEVELOPING COUNTRIES

**Alfred Maizels**


## *Abstract*

*The dominant feature of the markets for the non-oil commodity exports of developing countries since the early 1980s has been the persistence of exceptionally depressed commodity prices and a marked downtrend in the ratio of commodity prices to manufactures prices. As a result, developing countries have sustained large losses of foreign exchange earnings. Moreover, short-term price fluctuations have remained excessively high for many important commodities.*

*International action to raise depressed levels of prices could take the form of supply management to reduce the growth of supply and reduce the level of unsold stocks so as to bring about a better medium-term balance in the markets concerned. A new International Cocoa Agreement, adopted in 1993, involves a supply management scheme, while for coffee a producer-only export retention scheme began in October 1993. To the extent that these schemes prove successful, they could pave the way for such schemes for other commodities in structural surplus on the world market.*

*As regards short-term price fluctuations, any future international commodity agreements would need greatly improved mechanisms, compared with past agreements, particularly in the provision of adequate financing, greater operational flexibility, and support by national policies. The existing Compensatory Financing Facilities operated by the IMF and the European Union are inadequate and need to be greatly expanded. The futures and derivative markets can provide useful hedges against commercial risks of price fluctuation, but are unlikely to find widespread use by developing country exporters, at least for some years to come.*

*For countries heavily dependent on export of commodities in structural surplus, appropriate diversification into other commodities and/or manufactures and services sectors is needed. An expanded programme of financial and technical assistance, focused particularly on low-income countries, is also needed to assist them to identify and formulate diversification projects so as to attract greater external financial support.*

*Developing countries should consider evolving policies to protect the natural environment from degradation, both by fiscal policy and by appropriate regulation. A coordinated programme of research and development is needed to improve the competitive position of natural products facing competition from synthetics. Further efforts are required to reduce trade barriers to exports of processed commodities from developing countries.*

# I. Background: the continuing commodity crisis

## A. Overall commodity price trends

A dramatic change occurred at the beginning of the 1980s in the international markets for non-oil primary commodities[1]. Whereas the dominant feature in previous post-war decades had been abnormally short-term price fluctuations for a wide range of commodities, as from the early 1980s the dominant feature has been the persistence of exceptionally depressed price levels for a relatively prolonged period. The overall degree of short-term instability has been somewhat reduced, compared with the 1960s and 1970s, but for a number of important traded commodities short-term price fluctuations remain excessively high.

A major feature of the recent trend of real commodity prices[2] has been that whereas in the first half of the 1980s the decline in trend reflected almost entirely the fall in commodity prices, in the second half of the decade and into the early 1990s the further decline in the price trend was due wholly to a continued rise in manufactures prices, reflecting the inflationary pressures existing in the economies of the developed countries (see table 1). These developments are in sharp contrast with those of the 1970s, when the prices of both primary commodities and manufactures rose steeply, though at similar rates over that decade, so that the trend in real commodity prices was essentially unchanged.

During the 1980s, short periods of price recovery in 1983/84 and 1988/89 were superimposed on a sharp downtrend in real commodity prices. By 1990, the World Bank index of real non-oil commodity prices had fallen by just over 40 per cent from its 1980 level, while the corresponding (and broader based) UNCTAD index had declined by some 45 per cent.

These sharp falls in real commodity prices have been unprecedented over the whole period since the Second World War. Indeed, based on the commodity price index published by two World Bank economists (Grilli and Yang, 1988), which goes back to 1900, it would seem that the general level of real commodity prices had fallen by 1986 to below the nadir reached in 1932 during the Great Depression of the inter-war era. Moreover, by 1992, the World Bank index of real commodity prices was 17 per cent below the 1986 level, the corresponding decline on the UNCTAD index being 18 per cent.

There are several major factors behind the commodity price downtrend since 1980, on both the demand and supply sides of the international commodity markets[3]. On the demand side, a major element has been the slowdown in the growth rates of GDP and of industrial production, compared with earlier decades, in the OECD countries. This slowdown in growth resulted in a sharp retardation in the growth of demand for all industrial inputs, including primary commodities. The severity of the recession was due in part to restrictive monetary policies in some of the larger OECD countries - as part of the fight against inflation - and, to this extent, a significant part of the decline in the growth of demand for primary commodities can thus be attributed to economic policy decisions in those countries.

A second major element has been a longer-term downtrend in the consumption of natural raw materials per unit of GDP, or of industrial production. This reflects two separate processes. The first is the continuing displacement of natural materials by synthetics or other non-traditional substitutes in particular end-uses, while the second arises from technological change (the use of lighter materials, downsizing of products, less wastage, etc.) and change in industrial structures (relatively fast growth in industries such as electronics and information technology, which use less materials per unit of output than the traditional "heavy" industries). For many foods and beverages, a separate important factor has been the approach to saturation levels in per capita consumption in the industrial countries[4].

On the supply side, there has been a relatively

***Table 1***

**MOVEMENTS IN PRICES OF COMMODITIES[a] AND MANUFACTURES, 1960-1991**

*(Per cent per annum)*

| | 1960-1962 to 1970-1972 | 1970-1972 to 1979-1981 | 1979-1981 to 1983-1985 | 1983-1985 to 1989-1991 |
|---|---|---|---|---|
| Nominal prices (in $): | | | | |
| Commodities[b] | 1.5 | 11.2 | -3.7 | 0.9 |
| Manufactures[c] | 2.4 | 11.3 | -0.4 | 6.3 |
| Real commodity prices[d] | -0.9 | -0.1 | -3.3 | -5.4 |

***Source***: World Bank, *Price Prospects for Major Primary Commodities 1990-2005* (Washington, D. C.), various issues.
*a* Excluding petroleum.
*b* World Bank price index for 33 primary commodities.
*c* Unit value of manufactures exported by USA, France, Germany, Japan and UK, weighted proportionally to the countries' exports to developing countries.
*d* Ratio of nominal price indices for commodities and manufactures.

substantial growth in commodity production and exports. In a period such as that since 1980, when commodity prices have been abnormally low, it would appear perverse for supply to grow at all - yet increased supply appears to have combined with a fall in the growth of demand as the major reason for the general collapse in commodity prices. The reasons for the expansion in supply are, however, very different for producers in developed countries from those influencing production in developing countries.

In the developed countries, the output of temperate-zone agricultural products has been heavily subsidized by a variety of income-support mechanisms. For the OECD group of countries, the social cost of farm support programmes amounted to $320 billion in 1991 (OECD, 1992), a total three times the value of the entire exports of agricultural products from developing countries in that year.

These agricultural support policies, by raising prices in developed countries, result in reduced levels of domestic consumption and expanded domestic high-cost production. Market outlets in developed countries for lower-cost producers elsewhere are consequently reduced, particularly where imports are kept out by a variety of non-tariff barriers, while developed country surpluses are exported under subsidy, thus adding to supply on the world market. As a result, world prices are reduced, and they become more unstable than they otherwise would be, both of which involve economic losses for low-cost commodity exporters, whether developed (such as Australia and New Zealand) or developing.

By contrast, in most commodity-dependent developing countries, the main force behind the expansion in commodity production and exports since the early 1980s has been the extreme shortage of foreign exchange resulting from the collapse of world commodity prices, the high level of interest charges on their foreign debt, and the virtual drying-up of new commercial loans after 1982. The stabilization and structural adjustment policies adopted by an ever-growing number of developing countries, mostly as conditions for IMF and World Bank support, have usually included currency depreciation, among other measures, to promote exports and contract domestic demand. However, while these measures may improve the current balance of

payments of an individual country whose expansion of commodity exports is too small to influence the world price, similar policies applied to many countries simultaneously, as was the case for a variety of commodities in the 1980s, are likely to result in an export increase which will only add to the depressive forces in world commodity markets.

This perverse result (usually known as the "fallacy of composition") seems likely to arise when a number of developing countries are simultaneously forced to expand their traditional commodity exports in order to meet the service charges on abnormally high levels of foreign debt. Since world demand for each of the main commodities exported by developing countries is very price-inelastic, increases in total export supply will reduce prices by a percentage greater than the percentage increase in export volume. Consequently, exporters as a group can suffer large losses. This perverse effect of greater export efforts leading to reduced export earnings seems to have been a factor, to varying degrees, in the declining trend in prices and in earnings for cocoa, coffee and tea, and for a number of other major traded commodities[5].

### *B. Regional export trends*

The period since 1980 has also been one of sharp regional disparities in the trend of commodity exports. From 1980 to 1991, the volume of commodity exports more than doubled from the West Asia region (though from a relatively small base), and rose by some 60 per cent from South and South-East Asia, and by about 50 per cent from Latin America and the Caribbean. By contrast, commodity exports from North Africa were unchanged in volume in 1991, compared with 1980, while for sub-Saharan Africa (SSA) the rise was 15 per cent (table 2).

Africa's share of the world export market for commodities was thus seriously eroded. Moreover, the expansion in the volume of commodity export from SSA was heavily influenced by an increase of over 30 per cent for tropical beverages - the only commodity group in which African producers maintained their market share. Excluding tropical beverages, the volume of SSA commodity exports in 1991 was only marginally higher than in 1980, implying a substantial loss of market share in other primary commodities.

The lag in SSA export volume has been compounded by a greater fall in export unit values than those for other developing regions, largely as a result of the sharp decline in cocoa and coffee prices following the collapse of the International Cocoa and Coffee Agreements in 1989 and 1990, respectively. As a result, the value of SSA commodity exports in 1991 fell short of the 1980 value (by 15 per cent), whereas commodity exports from other developing regions taken as a whole were some 30 per cent higher in value terms (table 2).

In terms of purchasing power over imports of manufactures from developed countries, sub-Saharan Africa had the worst record for the period, with a fall of over 35 per cent between 1980 and 1991. For North Africa, the corresponding decline was also substantial - some 25 per cent - while for Latin America and the Caribbean the fall was some 15 per cent Exceptionally, the purchasing power of commodity exports from Asia was higher in 1991 than in 1980 - by almost 50 per cent for West Asia (partly a reflection of higher food exports from a relatively small base), while there was only a small increase, less than 10 per cent, for South and South-East Asia.

### *C. Terms of trade losses*

As a result of the deterioration in the trend of real commodity prices (i.e. in the commodity terms of trade) since 1980, the developing countries have suffered very large losses of foreign exchange earnings. Table 3 summarizes the calculation of these losses over the past decade[6]. For developing countries as a whole, the foreign exchange loss averaged over $25 billion a year, or a cumulative total of $290 billion over the

***Table 2***

**COMMODITY EXPORTS FROM DEVELOPING COUNTRIES BY REGION, 1980-1991**

| | Value | | Indices for 1991 | | | | |
|---|---|---|---|---|---|---|---|
| | 1980 | 1991 | Value | Unit value | Volume | Terms of trade[a] | Purchasing power[b] |
| | *($ billion)* | | *(1980 = 100)* | | | | |
| Africa: | | | | | | | |
| North | 3.5 | 3.5 | 100 | 100 | 100 | 74 | 74 |
| Sub-Saharan | 16.3 | 13.8 | 85 | 74 | 115 | 55 | 63 |
| Asia: | | | | | | | |
| West | 4.4 | 8.7 | 198 | 93 | 213 | 69 | 147 |
| South and South-East | 34.3 | 49.7 | 145 | 89 | 163 | 66 | 108 |
| Latin America & Caribbean | 46.3 | 53.8 | 116 | 78 | 149 | 58 | 86 |
| Total | 109.0 | 133.5 | 122 | 84 | 145 | 62 | 90 |
| Total, excluding SSA | 92.7 | 119.7 | 129 | 86 | 150 | 64 | 96 |

***Sources***: *UNCTAD Commodity Yearbook*, 1993 (New York: United Nations), UN, *Monthly Bulletin of Statistics* (various issues); UN trade tapes.

*a* Unit value of commodity exports deflated by UN index of unit value of manufactures exported by developed market-economy countries. This index was 135 for 1991 (1980 = 100).

*b* Volume index multiplied by terms of trade index.

whole 11-year period. One notable feature has been the sharp rise in the annual rate of loss, from just over $5 billion in the first half of the 1980s to over $30 billion in 1966-1968, and to almost $55 billion in 1989-1991. Expressed as a proportion of the value of non-oil commodity exports in 1980, the base year for the calculation, the annual average loss also rose rapidly from 5 per cent in 1980-1985 to almost 50 per cent in 1989-1991. On a cumulative basis, the loss over the whole period was equivalent to over 2.5 times the value of all non-oil commodity exports from developing countries in 1980.

A second notable feature has been a drastic shift in the relative contribution of the price (unit value) changes of commodities and manufactures to the terms of trade loss. Over the first half of the 1980s, prices of both commodities and manufactures fell, so that the resultant loss on commodity exports was largely offset by the gain in the purchasing power of those exports in terms of manufactured imports. But after 1985, manufactures prices began to rise mainly as a result of continuing inflationary pressures in the developed countries, so that both commodity exports and manufactured imports made substantial contributions to the overall loss of foreign exchange. Finally, by 1989-1991 the further increase in manufactures prices resulted in manufactured imports contributing well over half the total foreign exchange loss.

A comparison with the experience of the present group of developing countries during the Great Depression of the 1930s[7] - when their exports consisted almost wholly of primary commodities - shows that while during the first five years of the pre-war slump (i.e. 1930-1934) the annual terms of trade loss averaged 18 per cent of the pre-recession (i.e. 1929) level of exports, substantially greater than the

*Table 3*

**EFFECT OF CHANGES IN THE COMMODITY TERMS OF TRADE ON EXPORT EARNINGS OF DEVELOPING COUNTRIES, 1980-1991**

| | Terms of trade effects[a] | | | Total terms of trade effects as a proportion of: | | |
|---|---|---|---|---|---|---|
| | On exports[b] | On imports[c] | Total | 1980 commodity exports | 1980 total exports[d] | 1980 GDP |
| | *($ billion)* | | | *(Per cent)* | | |
| 1980-1985 | -16.9 | 11.6 | -5.3 | -4.9 | -0.9 | -0.3 |
| 1986-1988 | -19.8 | -14.2 | -34.0 | -31.2 | -5.9 | -1.6 |
| 1989-1991 | -22.1 | -31.9 | -54.0 | -49.5 | -9.4 | -2.6 |
| 1980-1991 | -19.1 | -7.3 | -26.4 | -24.2 | -4.6 | -1.2 |

***Source***: As for table 2; UNCTAD, *Handbook of International Trade and Development Statistics*, 1983 Supplement.
*a* Relates to non-oil commodity exports (see footnote 1). The figures are annual averages.
*b* Current value minus value at 1980 export unit values.
*c* Value at 1980 manufactures unit value minus current value.
*d* Includes petroleum and manufactures.

corresponding loss in the first half of the 1980s (6 per cent of the 1980 level), the position was sharply reversed in the subsequent four years (15 per cent, on average, for 1935-1938 as against 33 per cent for 1986-89). Moreover, as table 3 indicates, the rate of loss increased greatly towards the end of the 1980s and in the early 1990s. Thus, the impact of the current downtrend in the commodity terms of trade on foreign exchange earnings has been substantially more severe for the developing countries than was the case during the Great Depression of the 1930s.

The loss in earnings on commodity exports has also risen substantially since 1980 as a proportion of the total merchandise exports of developing countries (including petroleum and manufactures as well as primary commodities), and of their total GDP (see table 3). Since the petroleum exporting countries export only small amounts of non-oil commodities, a more useful comparison of the loss on the commodity terms of trade would be with the GDP of developing countries excluding the major petroleum exporters. On this basis, the ratio of the commodity terms of trade loss to GDP rises from 0.4 per cent in 1980-1985 to 2.7 per cent in 1986-1988, and to 4.3 per cent in 1989-1991.

A comparison with the real income loss suffered by the OECD countries as a result of the sharp increase in oil prices arising from OPEC action in 1973-1974 and 1978-1979 is instructive. On each occasion, the OECD secretariat has estimated that the increase in oil prices resulted in large real income transfers from the OECD countries amounting to 2-2½ per cent of their combined GDP (OECD, 1980). This was, however, a smaller relative loss than that suffered by the non-oil developing countries as a result of the worsening of their commodity terms of trade since 1985.

The regional distribution of terms of trade losses on commodity exports is shown in table 4 for the period 1989-1991. Sub-Saharan Africa suffered the greatest loss in relation to the 1990 level of commodity exports (over 50 per cent

*Table 4*

**COMMODITY TERMS OF TRADE EFFECT BY MAJOR REGION, 1980 TO 1989-1991**

| | Total terms of trade effects | Total terms of trade effects as a percentage of: | | | Change in ODA, 1980 to 1989[b] |
|---|---|---|---|---|---|
| | | 1990 commodity exports[a] | 1990 total exports[a] | 1990 GDP | |
| | *($ billion)* | | | | *($ billion)* |
| Sub-Saharan Africa | -8.2 | -54.3 | -20.3 | -4.9 | 5.7 |
| South and South-East Asia | -16.8 | -35.8 | -4.4 | -1.4 | -0.8 |
| Latin America and Caribbean | -24.2 | -42.8 | -18.0 | -2.2 | 1.7 |
| Other regions and unspecified | -4.8 | -28.9 | -2.7 | -0.4 | -5.6 |
| Total | -54.0 | -40.0 | -7.3 | -1.5 | 1.0 |

***Source:*** As for table 3; OECD (1992).
*a* See footnotes a and d to table 3.
*b* Change in ODA (net disbursements from all sources) at 1990 prices and exchange rates.

annually, on average), followed by Latin America and the Caribbean (over 40 per cent). For both regions, the unit value of commodity exports was exceptionally depressed in 1990 and 1991 as a result of the sharp fall in prices of coffee and cocoa. Both regions also suffered substantial losses of relation to their total merchandise exports, reflecting the much higher weight of primary commodities in their total exports compared to South and South-East Asia.

In relation to GDP, the commodity terms of trade loss was exceptionally high for sub-Saharan Africa (almost 5 per cent). It seems apparent that the relative burden of the commodity price recession has fallen disproportionately on the foreign earnings of the poorest region of the developing world.

It is of interest to compare the commodity terms of trade losses of the different regions with the change in official development assistance in real terms over the same period (last column of table 4). There has clearly been a marked shift in the regional distribution of aid in favour of sub-Saharan Africa, though the increase in aid to that region fell short of the annual terms of trade loss during 1989-1991. For both South and South-East Asia, and Latin America and the Caribbean, however, the change in aid since 1980 was purely marginal.

Though the terms of trade losses since 1980 cannot be precisely related to the growth in the foreign debt of developing countries, since the relationship is a complex and changing one, it is clear that the commodity terms of trade deterioration must have been a major factor in the emergence of the huge debt overhang of a large number of countries. The foreign debt statistics for the early 1980s were compiled on a somewhat different basis from those for later years, but a valid comparison can be made for the second half of the decade. Excluding the major petroleum-exporting countries, the total external debt of developing countries rose from $796 billion in 1985 to $991 billion in 1990, an increase of $195 billion.

Many developing countries which experience an unexpected shortfall in foreign exchange earnings will endeavour to borrow abroad at least

some proportion of the shortfall. If it is assumed that there is, on average, a one-year lag between shortfall and new borrowing, then the terms of trade loss in the years 1984-1989, amounting in total to some $155 billion on commodity exports would represent nearly 80 per cent of the debt increment of $195 billion. This percentage is not intended to be an accurate measure of the impact of changes in the commodity terms of trade on the external debt of developing countries - as indicated earlier, there are many other factors involved, such as the high interest rates on external debt during the 1980s, the terms of debt renegotiations including the capitalization of deferred interest, and the proportion of grants to loans. However, the comparison of terms of trade loss with debt increment does indicate that the sharp downtrend in real commodity prices was almost certainly one major factor in the huge rise in the external debt of developing countries over the past decade.

This would indicate that the current international strategy to reduce the debt-service burden of developing countries, even if successful in meeting its immediate objectives, may not lead to increased economic growth in many commodity-dependent countries in the absence of a complementary strategy designed to increase commodity prices and export earnings from abnormally low levels.

### *D. Short-term commodity market instability*

As already mentioned, though the world market for the commodity exports of developing countries has been dominated since the early 1980s by a downtrend in real commodity prices, short-term fluctuations around the trend have remained substantial. A summary view of the degree of short-term price instability for all the commodities included in the UNCTAD commodity price index is given in table 5 for the decades of the 1970s and 1980s. Two main conclusions can be drawn from these instability indices. First, the sharp downtrend in commodity prices during the 1980s was accompanied by a substantial reduction in the degree of price instability for four major commodity groups, viz. food, tropical beverages, vegetable oilseeds and oils, and agricultural raw materials. The minerals, ores and metals group was exceptional in exhibiting an increase in short-term price instability in the 1980s compared with the 1970s.

Second, two-fifths of the commodities covered (17 out of 43) were subject to a high degree of price instability in the 1980s (defined here as an instability index exceeding 20 per cent) which, though a substantial proportion, was markedly lower than that for the 1970s (28 out of 43, or two-thirds of the total). The 17 commodities with high instability in the 1980s together accounted for 22 per cent of the value of commodity exports from developing countries of all 43 commodities in the years 1983-1985, so that short-term price instability remains a serious problem for many countries which are dependent on one or two of the high-instability commodities for a substantial proportion of their export earnings.

The instability problem is greatest for sugar, with an instability index exceeding 50 per cent in both the 1970s and 1980s - far above the corresponding indices for almost all other high-instability commodities. The underlying reason for this is that the world sugar market is fragmented as a result of the high price supports provided by most developed countries to domestic sugar production, which entails the virtual exclusion of imports from developing countries and other low-cost producers apart from those imported under preferential arrangements. The "free market" in sugar is thus a residual market, subject to irregular and often large changes in subsidized exports from the European Union, as well as changes in supply from low-cost producers due to climatic and other factors. Other commodities with exceptionally high price instability include most vegetable oils and oilseeds, nickel, lead and manganese ore.

Countries heavily dependent on high-instability commodities for the bulk of their export earnings are generally acknowledged to be subject to extra constraints on their economic development. These constraints may arise from

***Table 5***

**SHORT-TERM PRICE-INSTABILITY INDICES**

| | Number of commodities | Instability indices[a] | | Degree of instability, 1980-1991[b] | | |
|---|---|---|---|---|---|---|
| | | 1970-1982 | 1980-1991 | Low | Medium | High |
| | | *(Percentage variation)* | | | | |
| Food | 9 | 29.7 | 20.9 | Beef (6.9) | Bananas, fishmeal, maize, soyabeans meal, wheat (13.7) | Pepper, rice, sugar (37.8) |
| Tropical beverages | 3 | 27.0 | 14.0 | - | Coffee, cocoa, tea (16.0) | - |
| Vegetable oilseeds and oils | 10 | 22.4 | 16.4 | - | Groundnuts, soyabeans, soyabean oil, sunflower oil (11.6) | Coconut oil, copra, groundnut oil, palm oil, palm kernels, palm kernel oil (26.0) |
| Agricultural raw materials | 11 | 15.1 | 9.0 | Tobacco, sisal (7.3) | Cotton, hides and skins, plywood, rubber, tropical sawn-wood, tropical logs (15.5) | Jute, linseed oil (23.3) |
| Minerals, ores and metals | 10 | 13.7 | 15.3 | Iron ore (7.4) | Phosphate rock, tin, tungsten, zinc (15.4) | Aluminium, copper, lead, manganese ore, nickel (26.2) |
| Total | 43 | 18.8 | 13.0 | -7.2 | -14.5 | -27.9 |

***Source:*** *UNCTAD Commodity Yearbook*, 1990 and 1992, table A.2.

*a* Percentage variation from exponential trend, calculated for each of the 43 commodities in the UNCTAD monthly commodity price index.

*b* Defined as : low = under 10 per cent variation; medium = between 10 and 20 per cent; high = over 20 per cent. The percentages in brackets are the unweighted means of the indices for the individual commodities listed.

the effects of fluctuations in export earnings on the volatility of domestic savings and of government revenue and expenditure, and hence on domestic investment. Probably a more important adverse effect of export instability is on the variability of imports of capital goods and intermediate products, and thus, once again, on domestic investment.[8] These and related constraints on development are likely to be greater, the more dependent a country is on exports of high-instability commodities, and the smaller its natural resource base and the level of skills of its population, so that its potential for diversifying away from high-instability commodities is limited.[9]

## II. International commodity policy

### *A. International commodity agreements*

The development of an acute foreign exchange crisis for a wide range of commodity-dependent countries since the early 1980s has been paralleled by an increasing disarray in international commodity policy.

During the earlier post-war period there had been a general consensus among both developed and developing countries on the need to reduce excessive short-term fluctuations in the markets for the commodity exports of developing countries, and on the need for commodity prices to be "remunerative for producers and equitable for consumers". International negotiations were focused on the establishment of commodity stabilization agreements using either export quotas or buffer stocks, or both, to maintain prices within a range agreed as "remunerative and equitable".

By the beginning of the 1980s, five such agreements had been negotiated (or renegotiated), viz. those for cocoa, coffee, natural rubber, sugar and tin which, together, represented about 20 per cent by value of total non-oil commodity exports of developing countries. In addition, intensive negotiations had been under way in UNCTAD for the establishment of similar agreements for a large number of other commodities.

However, by the end of the 1980s all five existing agreements had lapsed or become non-operative, while the negotiations for agreements on other commodities had all broken down. The 1990s thus opened with no effective market stabilization mechanisms in place and, moreover, no consensus between developed and developing countries on the need for such mechanisms, either now or in the future. What explains this impasse in international policy on commodities and what are the prospects for the future?

It is necessary, to begin with, to consider the reasons for the effective collapse of all five existing international commodity agreements. There were, of course, particular factors operating in each case which tended to undermine the agreement. Many of these factors were essentially technical - e.g. disputes on quota allocations, or growing production by non-member countries - but some general factors can also be discerned which adversely affected the operation of the agreements (Maizels, 1992, chapter 8).

One such general factor was that all the agreements were designed to deal essentially with excessive short-term price fluctuations in a world economic environment much less hostile than that of the 1980s. Thus, none of the agreements was equipped with the mechanisms or financial resources to cope with a downward trend in the commodity terms of trade of unprecedented magnitude and duration. A second general factor was the emergence of a sharp difference of view, as between developed consuming countries and developing producing countries as to the meaning of "price stabilization", and hence as to the central function of the agreements. During the price collapse of the 1980s the producers argued that the mechanisms of an agreement should be used to defend the "floor" prices of the agreed price range, so as to act as a safety net to protect their depleted export earnings. The consumers, on the other hand, insisted that in a period of falling

prices the agreed price range had to be adjusted downwards to keep in line with market trends. This conflict of view became even more acute as the downward trend in commodity prices continued.

A third general factor was that from about 1980 the Governments of certain of the larger developed countries were actively promoting the concept of the "magic of the market", and were generally hostile to the concept of intervention in the international commodity markets even where the objective of such intervention was to reduce short-term price fluctuations (and not to raise depressed levels of prices). Thus, when the difference of view regarding the stabilization function of a commodity agreement became acute, these governments preferred to let the agreement lapse rather than to reach a negotiated compromise solution. This appears to have been a major factor in the collapse of the agreements for cocoa (1988) and coffee (1989).

Opposition by the larger developed countries to proposals to raise commodity prices above currently depressed levels would, if anything, be even stronger than their opposition to intervention to reduce short-term fluctuations. One argument often put forward in this regard is that maintenance of prices above market trends would result in a misallocation of resources by encouraging increased production and would therefore ultimately be self-defeating.

While there is indeed a danger of encouraging excessive production when prices are maintained substantially above world market trends - as, for example, is the case with subsidized high-cost agriculture in developed countries - this problem seems unlikely to arise, at least to a major extent, if current depressed prices of commodity exports of developing countries were raised by only a modest amount, such as half-way back to the 1980 level. None the less, measures to meet the potential danger of overproduction - such as appropriate diversification programmes - will be required to complement market intervention to raise depressed levels of prices.

The argument based on misallocation of resources and probable overproduction is, moreover, not very convincing when advanced by developed countries, since these countries have themselves traditionally used widespread mechanisms of market intervention, including trade barriers and subsidies to high-cost domestic producers, over virtually the whole range of agricultural output. A more convincing explanation of their opposition to intervention in the international commodity markets is that they have been making large terms of trade gains, which they do not wish to forego, as a result of the continuing fall in prices of commodity exports of developing countries combined with the rise in prices of their manufactured exports in the reverse direction.

If the non-interventionist approach prevails, a new equilibrium in many commodity markets may ultimately be reached, at reduced levels of production and at high cost to developing countries in terms of reduced real income, employment and living standards. In the meantime, the continuing foreign exchange squeeze is likely to inhibit, or at least limit, the new investment required for the adaptation of the economic structures of many commodity-dependent countries to support long-term growth and development. In any event, the cycle of overproduction followed by glut followed at a later stage by another round of overproduction would seem set to continue.

### *B. Policy options for the future*

It would seem evident from the earlier analysis of the effects of the downward trend in real commodity prices since the early 1980s that international commodity policy should now be focused on measures to raise current depressed levels of prices for those commodities for which international action to achieve this objective would be feasible. Such action, even if related to only a relatively few important commodities, would in itself be a significant first response to the central international commodity problem facing the developing countries at present. The associated problem of excessive short-term

commodity price fluctuations remains acute, and effective solutions are now urgently required.

Of course, the commodity markets differ greatly as regards the relative importance of short-term and longer-term problems of trade barriers and other forms of government intervention, of control over trade channels by large transnational corporations, or of the inroads of synthetic and other substitute materials into the traditional markets for natural products. A recent UNCTAD paper makes a useful distinction between three broad groups of commodities. The first includes those commodities in structural surplus (e.g. cocoa, coffee, sugar, cotton and natural rubber), some of which also have large stock "overhangs". The general problem faced by commodities in this group is the "inability of supply to adjust downwards in response to falling prices" (UNCTAD, 1993a, para. 18).

A second group includes commodity markets which exhibit medium-term imbalances between supply and demand, but for which, over a long period, demand growth has matched the growth in supply. These commodities (which include many minerals and metals such as copper, iron ore, aluminium, zinc, nickel and petroleum, and a few other agricultural commodities such as bananas, soyabeans and groundnut oil and tobacco) generally have supply adjustment problems related to the inability to prevent large swings between periods of excess and insufficient supplies (UNCTAD, 1993a, para. 19).

The third UNCTAD group covers relatively few commodities (including hard fibres, tin, tungsten and manganese) for each of which the market has been severely depressed for a long period as a result of downwards shifts in demand (UNCTAD, 1993a, para. 20). It is useful to divide this group into two, viz. those commodities (e.g. jute and sisal) for which the downtrend in demand is mainly a result of displacement by synthetic materials or other substitutes, and those (e.g. tin, tungsten and manganese) where the problem reflects other factors (e.g. the effects of new technologies, or of a shift in demand patterns).

This kind of grouping is useful if it can help to identify the causes of the various problems identified, and so point the way to potential remedial action. A useful distinction can be made between policies which involve some kind of intervention in the working of an international commodity market, and policies which do not involve such intervention. The main market intervention policies to be considered include some form of supply management designed to raise prices from currently depressed levels, combined with appropriate programmes of diversification affecting the commodity sector of the economies of producing countries; the traditional short-term stabilization mechanisms (buffer stocks and export quotas); GATT negotiations to reduce barriers to the commodity exports of developing countries; internationally financed and coordinated research and development (R&D) programmes for commodities competing with synthetics in their main end-uses; and diversification where the problem is essentially a secular decline in demand rather than a structural excess supply.

The main non-interventionist policy options relate to measures designed to offset the adverse effects of commodity market instability. Compensatory finance now has a long history (the IMF Compensatory Financing Facility was created in 1963), but the risk management concept is relatively new. Both compensatory finance and risk management are discussed in section IV.

## III. Raising depressed levels of prices by supply management

Since the severe commodity price recession of the past decade essentially reflects a faster growth in commodity supply than in demand, the most direct measure to raise depressed levels of prices would be some form of supply management designed to reduce the growth of supply - and, where appropriate, to reduce the level of unsold stocks - so as to bring about a better medium-term balance between supply and demand.

Supply management is not a new idea. Indeed, all developed countries have operated supply management schemes for domestic farm production for a very long time. These schemes have involved price supports for major agricultural products, subsidies for exports, deficiency payments, often subsidies for essential farm inputs and, for certain products, arrangements for land to be taken out of production. There have also been international agreements involving developed countries designed to stabilize particular commodity markets or to raise particular commodity prices to levels more remunerative to producers. One example is the International Dairy Arrangement, negotiated in GATT, which became operative in 1980 and which establishes minimum export prices for a number of milk products. Other examples of action by developed countries to support prices of commodities exported by developing countries include the preferential prices paid by the European Union for sugar and bananas from ACP countries (i.e. those associated under the Lomé Agreements), and United States imports of sugar from designated Caribbean countries, also at preferential prices well above the free market level.

In view, however, of the opposition of the major developed countries to a more general use of supply management schemes in the markets for commodities exported by developing countries, the question arises as to whether the producer countries themselves can devise such schemes and operate them successfully without the active cooperation of developed consuming countries. A number of conditions would now have to be satisfied to ensure the success of a particular scheme including, in particular, the following:

(1) world demand for the commodity should be inelastic, so that a given restriction of supply will result in a more than proportionate increase in the world market price;

(2) world supply of the commodity should be wholly or mainly by developing producing countries;

(3) the scheme should be supported by all the main producing countries, including new producers with potential for substantial increases in production;

(4) it should be modest in its objectives, so that it could be accepted as fair and reasonable by consuming countries;

(5) policing the scheme to ensure compliance with agreed supply management rules should be reliable and not difficult to enforce.

The first two conditions, relating to supply and demand in the world market, are in fact quite restrictive in view especially of the wide range of commodities produced in developed countries. Those produced wholly or mainly in developing countries would include the tropical beverage crops - cocoa, coffee and tea - and other tropical products such as fruits, spices, etc., and certain minerals and metals. Of these, the tropical beverage group is by far the largest in value terms. In 1986, when tropical beverage prices were at a peak, the group accounted for almost 20 per cent of all non-oil commodity exports from developing countries, while for sub-Saharan Africa the proportion was as high as 43 per cent; by 1991, however, the relative importance of tropical beverage exports had fallen sharply as a result of the fall in prices, to 8.5 per cent for all developing country non-oil commodity exports, and to 23 per cent for those from sub-Saharan Africa.

The second half of the 1980s was broadly the period in which producing countries suffered large terms of trade losses as a result of the fall in prices of tropical beverages, and the concurrent rise in prices of imports of manufactured goods from developed countries. Had some form of supply management been in operation over this period, which met conditions (3) - (5) above, as well as the purely economic conditions (1) and (2), then these terms of trade losses could have been largely - or even wholly - avoided. This conclusion is confirmed by an econometric study recently completed which simulated the effects of alternative supply management schemes for cocoa, coffee and tea on production, consumption,

stocks, prices and export earnings (Maizels et al., 1994).

Of the various alternatives, production cuts or the traditional type of export quota scheme emerged as the most efficient, in the sense that a given percentage change in supplies yielded the largest gain in world prices and in export earnings. For cocoa, one additional alternative simulated was a stock reduction scheme on the lines of the informal scheme for tin which has been operated by producing countries since shortly after the collapse of the International Tin Agreement in 1985. While such a scheme for cocoa could have improved export earnings substantially, this would have involved a large percentage cut in stock levels. A final alternative considered was the imposition by producer countries of a uniform *ad valorem* export tax. However, this was clearly not a preferred alternative, since a very large tax would have been required to achieve the same revenue increase as would quite a small percentage cut in production or exports. Moreover, an export tax would not be a viable option for coffee (in view of the price inelasticity of production in the short-term), while for tea its use was problematic (in view of the likelihood that it would divert part of India's exportable production to the domestic market).

While this study on supply management for tropical beverages was being completed (spring 1993), negotiations were proceeding for new international agreements on cocoa and coffee. For cocoa, a new agreement, adopted in July 1993, aims to achieve equilibrium between supply and demand by means of adjustments of production and the promotion of consumption. A supply management scheme is envisaged within the framework of the agreement, of which both producing and consuming countries are members. A Production Committee is to be established to fix indicative figures for annual levels of global cocoa production necessary to achieve and maintain equilibrium between supply and demand. Each producing member country would then draw up a programme for the adjustment of its production, and the results will be reported to the International Cocoa Council. This appears to be the first time that a consensus has been reached between producers and consumers on the need for market intervention measures to raise the price of a commodity in structural surplus on the world market. Moreover, the agreement would give priority to the issue of raising depressed price levels over the traditional concern with short-term price stabilization, though if the production regulation mechanism works effectively, short-term price instability may also be reduced.

For coffee, however, negotiations for a new agreement broke down in early 1993, following which the main producing countries negotiated among themselves an export retention scheme, which came into operation on 1 October, 1993. The scheme envisages the retention by each member country of 20 per cent of exportable production while the coffee indicator price remains below 75 U.S. cents/lb., reducing to 10 per cent retention while the price is between 75 and 80 cents/lb., with no retention above 80 cents/lb. As a result of this producer-only agreement, the United States withdrew from membership of the International Coffee Organization in September 1993. Thus, the operation of a supply management scheme for coffee is proceeding against a background of producer-consumer confrontation, in sharp contrast to the position for cocoa.

For other commodities in structural surplus on the world market, and for which supply management would be technically feasible, there has been virtually no post-war experience of producer-country cooperation to maintain agreed levels of prices[10]. Simulations of the effects of alternative types of supply management schemes would be a necessary prelude, in such cases, to any consideration of a producer-only scheme.

One issue which must be addressed in whichever type of supply management scheme is adopted is how best to allow for changes in demand patterns, and for changes in the comparative advantages of the different producing countries. Changes in demand patterns are likely

to be important for commodities such as coffee which comprise different varieties. In such cases, including the recent export retention scheme for coffee, production or export quotas should be flexible enough to allow supplies of the different varieties to change at different rates in line with demand patterns.

Changes in country quotas to allow for shifts in comparative advantage have always been a contentious issue in international commodity stabilization schemes based on export quotas, and no fully satisfactory solution has yet been found. One suggested procedure would be for a semi-automatic indicator to be adopted which would combine some of the principles used in earlier international commodity agreements, e.g. recent export performance, current levels of stocks and the importance of the commodity in the exports of individual countries (Maizels, 1992, pp. 82-84). Changes in an indicator on these lines could then be used as one element in annual renegotiations of country quotas.

Though supply management would be a viable policy for commodities satisfying the conditions listed above, it cannot be taken as a panacea for the longer-term problems of producing countries in a prolonged period of excess supply. Even with a supply management scheme in operation, countries with relatively high costs of production will need to consider diversifying away from the commodity concerned and into more dynamic lines of activity, including the manufacturing and services sectors. The main issues involved in this process are considered further in section V. Here it suffices to point to a possible link between supply management and diversification in so far as some proportion of the increase in export earnings resulting from supply management can be made available to finance needed diversification and longer-term structural change. To this extent, supply management could not only alleviate the immediate foreign exchange difficulties of producing countries, but could also make a useful contribution to laying the basis for sustainable growth in the future.

## IV. Reducing the adverse effects of excessive commodity market instability

### *A. Buffer stocks and/or export quotas*

The various post-war international commodity agreements designed to maintain prices within an agreed range so as to minimize short-term fluctuations - those for cocoa, coffee, sugar, natural rubber and tin - employed either buffer stocks or export quotas, or both, to achieve this objective. The appropriate stabilization mechanism chosen reflected, inter alia, the particular problems of the world market for the commodity concerned. For a commodity in persistent surplus on the world market, for example, the use of a buffer stock alone to defend the floor price of an agreement is likely to fail unless the buffer stock had virtually unlimited financial resources. In such cases, an export quota, or a combined export quota/buffer stock scheme, would be more appropriate.

A detailed review of the experiences of the various agreements would be outside the scope of the present paper[11]. But there were clearly several important operational or technical defects[12] which limited their effectiveness, and in some cases contributed to their collapse. These and other technical difficulties could have been overcome given willingness by Governments to do so. However, as pointed out earlier, by the beginning of the 1980s certain of the larger developed countries became active exponents of the virtues of market forces, and hence developed a negative attitude to the mechanisms of market stabilization traditionally used by the various international commodity agreements.

At first, this negative attitude was expressed as objections to the use of export quotas, in contrast to buffer stocks. Export quotas, it was claimed, by their restrictive influence on production, will tend to raise the price *trend* (even though this was not the intention), whereas buffer stocks cannot do so (since they can be assumed to have limited resources). Another criticism made of export quotas was that while they may be effective in

defending the "floor" price of an agreement in a period of oversupply, they are useless in defending the "ceiling" price in a period of shortage. Thus, it was argued, export quotas are unfair to commodity-importing countries. For these and related reasons, the developed countries showed a strong preference for the use of buffer stocks as the stabilizing mechanism when an existing agreement was being renegotiated, or a new agreement was being considered.

For example, while the earlier cocoa agreements had relied on both buffer stocks and export quotas, the renegotiated 1980 agreement was based only on a buffer stock at the insistence of the larger developed countries, particularly the United States. A similar outcome was reached on the negotiations for the 1979 Natural Rubber Agreement. As a result, the efficacy of both these commodity agreements in defending their respective floor prices was considerably reduced, as was seen during the price collapse of 1980-1982.

Later in the 1980s, even buffer stocks fell out of favour with the larger developed countries, which began to press for international agreements incorporating "development" measures (such as productivity improvement, cost reduction and market promotion), instead of price stabilization. This new type of "development" agreement was negotiated for jute and jute products in 1983, and for tropical timber in 1984. However, agreements which ignore the immediate export difficulties of producer countries are unlikely to retain their full support. Discussions in 1989 on a renewal of the International Jute Agreement, for example, were marked by proposals by Bangladesh and India, the leading exporters, for the introduction of a price support mechanism and the use of a buffer stock when the agreement was renegotiated. However, the International Jute Agreement was extended for a further five years without a price support mechanism, on the insistence of the main developed countries.

It should be pointed out that both arguments mentioned above against the use of export quotas are over-simplistic. As regards the effect on the price trend, this will depend essentially on whether the quota results in a restriction of productive capacity. In a situation of oversupply, the price in free market conditions would fall - almost by definition - below the floor price which would have been defended by an export quota. Thus, any reduction in productive capacity is likely to be greater during a price slump without an export quota than if such a quota were in force. In many cases, the main effect of an export quota may thus be to reduce the amplitude of the fluctuation in market prices rather than to raise the price trend. However, if productive capacity is, in fact, adversely affected as a result of an export quota, the price cycle itself is likely to be shortened, since the reduction in capacity would tend to raise prices sooner than they would otherwise rise once demand had begun to expand in the upward phase of the cycle[13].

As regards the argument that export quotas are unfair to commodity-importing countries because quotas cannot defend the ceiling price of an agreement, it is useful to distinguish several broad groups of commodities. First, there are temperate-zone foods, the production of which is heavily subsidized in developed countries. High and assured levels of subsidy have resulted in large increases in production, a limitation of demand, the accumulation of large stocks, and an expansion of exports. World prices of the subsidized products, particularly foods such as cereals and sugar, have been reduced as a result, and their prices on the world market have become more volatile. Thus, agricultural protectionism in developed countries has clearly been unfair to low-cost exporters of agricultural products, and any inequity to developed countries resulting from the failure of an export quota to defend a price ceiling would be merely a partial compensation - and a very small one - for the economic losses imposed on exporters by agricultural protectionism.

Agricultural raw materials, a second group, generally face substantial competition from synthetic materials, so that the agreed ceiling price of an agreement would need to be in the region of the substitution threshold price to be realistic.

Thus, in a period of shortage, market forces are likely to operate to keep prices in the region of the agreed ceiling. A third group consists of the tropical beverage crops (cocoa, coffee and tea). For these, market prices have been subject to wide fluctuations, so that the use of export quotas would need to be supported by buffer stocks in order that an agreed ceiling price would be defended effectively.

### *B. Towards more effective commodity agreements?*

Clearly, one reason for the lapsing or collapse of the various international commodity agreements (ICAs) over recent years has been a series of technical and design deficiencies. Though it may be many years before a new series of ICAs is seriously considered, it seems worth while to point to some of the more important changes which would need to be incorporated in order that such ICAs could effectively carry out a price-stabilizing function in the future.

First, much more care needs to be taken than hitherto in matching the finance available for buffer stock operations to the probable amplitude of fluctuation in market prices and to the desired degree of price stabilization. More specifically, quantitative estimates of the optimum size of a proposed buffer stock, preferably by the use of an econometric model, should be made, and assured sources of finance established. The Common Fund could play a useful role here as a pool for buffer stock financing. Second, provisions would be needed to inject greater flexibility into the operation of ICAs, particularly in periodic changes in country quotas. Third, some means should be found to ensure that national policies are supportive of the objectives of an ICA and do not undermine those objectives. The classic example of the latter is the severe downward pressure on world sugar prices, and their exceptionally high instability, resulting largely from overproduction of subsidized sugar in developed countries, the consequent fragmentation of the world sugar market, and the rapid increase in the use of sugar substitutes, encouraged partly by high domestic sugar prices in the United States.

Finally, serious consideration needs to be given to whether it is any longer sensible for ICAs to operate within a standard time horizon of five years. This necessarily results in a tendency to ignore, or gloss over, underlying longer-term issues such as the need for diversification programmes, for extended R&D, or for needed changes in market structures.

Any consideration of the future of the ICA approach must also take into account the attitudes of developed country Governments. It seems clear that these Governments remain convinced that commodity price fluctuations constitute a problem for developing exporting countries, but not for developed importing countries. Though it is accepted that the gyrations in petroleum prices have caused problems of adjustment in their economies, developed country Governments regard that as a special case, not applicable to price fluctuations of other primary commodities. The quantitative analysis of the role of commodity price fluctuations in the economies of developed countries thus remains a key topic for further research in the area of international commodity policy[14].

### *C. IMF compensatory finance*

Another approach to reducing the adverse effects of commodity price instability on the economies of developing countries is to create mechanisms which, while not intervening in market operations as do export or production quotas, retention schemes, export taxes, etc., help to alleviate or offset these adverse effects. Of these mechanisms, compensatory finance is by now well established, while in very recent years interest has been growing in the use of risk management systems based on futures and related contracts, and on possible measures to reduce existing distortions in the functioning of commodity markets which could bring benefits to both producers and consumers.

The general case for compensatory finance is that even if a number of price-stabilizing ICAs were successfully in operation, export earnings of individual commodity-dependent countries would still fluctuate owing to fluctuations in the volume of their commodity exports. For reasonably complete coverage of the temporary shortfalls in commodity export earnings of developing countries, it would be necessary to combine the two approaches, i.e. having a series of price-stabilizing ICAs, supported by a central fund for compensating individual countries for any residual export shortfalls. A compensatory finance system operating alone, without the support of price-stabilizing ICAs, would clearly need far greater financial resources to achieve a given degree of stabilization than it would need if it acted as part of a mutually supportive system.

The IMF established a Compensatory Financing Facility (CFF) in 1963 as a low-conditionality support for member countries in meeting temporary shortfalls in export earnings caused largely by circumstances beyond the country's control. As a result of the sharp fall in commodity prices in the early 1980s, drawings by developing countries on the CFF rose from SDR 1.0 billion in 1980 to 2.6 billion in 1983. However, in the latter year the IMF changed the loan conditions under this facility to ones of strict conditionality, as a result of which compensatory drawings fell off sharply and have remained at a lower level since (see table 6).

After 1982, repayments on earlier loans under the CCF began to rise, and over the period 1984 to 1987, there was a net financial flow from developing countries back to the IMF. Then, in 1988 the CFF was incorporated into a new Compensatory and Contingency Financing Facility (CCFF), to provide contingency finance for IMF-supported structural adjustment programmes to cover unanticipated external shocks which were beyond the control of a country. The facility was extended in 1990 to cover losses resulting from shortfalls in receipts from services (e.g. transport, insurance, pipelines, etc.), while in 1990 also a compensatory oil import facility was temporarily added, which expired at the end of 1991. There were, in fact, a large number of drawings in 1991 for the excess cost of oil imports - reflecting unanticipated costs associated with the Gulf war - and, excluding these, there was still a net outflow from developing countries under the CCFF of little short of SDR 1.0 billion over the years 1988 to 1992.

Most of the drawings under both the CCF and the CCFF were made by large commodity exporters with low commodity-dependency, with India, Argentina, Brazil and the Philippines accounting for over 40 per cent of total drawings over the decade to 1992 (UNCTAD, 1993b). Low-income countries, by contrast, made few drawings up to 1988 and none thereafter, essentially because of the high conditionality imposed, together with the relatively high interest rate charged on loans. A new Structural Adjustment Facility (SAF) was established in 1986 to provide balance of payments assistance on concessional terms to low-income countries. In 1987, the IMF also established the Enhanced Structural Adjustment Facility (ESAF) to increase concessional lending to low-income countries undertaking macro-economic and structural adjustment programmes. Between 1988 and 1992, 36 drawings were made totalling SDR 3.5 billion under the two Facilities, the main beneficiaries being the low-income, highly commodity-dependent countries of Africa.

In its recent review of these developments, the UNCTAD secretariat comments that by "encouraging low-income developing countries to use these facilities [i.e. SAF and ESAF] instead of, or alongside, the CCFF, it is clear that the Fund now views balance of payments difficulties as signalling a structural problem rather than a short-term self-revising fluctuation in export earnings for which drawings from the CCFF were seen as a quick disbursing short-term solution" (UNCTAD, 1993b, para. 16). The UNCTAD paper concludes that the CCFF, which was designed to cope with intermittent country-level difficulties, does not seem to be an appropriate instrument for addressing the problems of export earnings shortfalls which are mostly "not of a

*Table 6*

**DRAWINGS AND REPAYMENTS BY DEVELOPING COUNTRIES UNDER IMF COMPENSATORY AND STRUCTURAL ADJUSTMENT FACILITIES, 1980-1992**
*(SDR billion)*

| | 1980-1983 | 1984-1987 | 1988-1992 | Total |
|---|---|---|---|---|
| Drawings under: | | | | |
| CCF + CCFF | 6.2 | 3.4 | 3.6[a] | 13.2 |
| SAF + ESAF | - | ... | 3.5 | 3.5 |
| Total | 6.2 | 3.4 | 7.1 | 16.7 |
| Repayments under: | | | | |
| CCF + CCFF | -2.5 | -6.6 | -3.6 | -12.7 |
| Net financial flow to developing countries | 3.7 | -3.2 | 3.5 | 4.0 |

***Source:*** Information provided by the IMF quoted in UNCTAD (1984 and 1993a).
*a* Including some SDR 0.9 billion under the oil import facility.

short-term, reversible nature, but are due to persistent structural imbalances at the world commodity level" (UNCTAD, 1993b, para. 20). This judgement seems justified and is fully consistent with the conclusion reached in section I that since 1980 the predominant problem facing commodity exporting countries has been falling or depressed levels of prices rather than short-term price fluctuations.

Moreover, the volume of finance available under the various IMF facilities has been only a fraction of the total of short-term export shortfalls since 1980. Calculations of commodity sector export shortfalls for 93 developing countries over the period 1980-1989 yielded a cumulative total of some SDR 42 billion, of which SDR 22 billion (over one-half of the total) were for Latin America, and SDR 10 billion each for Africa and Asia (about one-quarter of the total in each case). Over this period, total drawings by developing countries under the various IMF facilities, net of repayments, amounted to only a marginal SDR 2.0 billion, or some 5 per cent of total shortfalls[15]; for the least developed countries, the corresponding coverage was 15 per cent, but generally the impact of net IMF compensatory flows was clearly inadequate in the circumstance of a general downtrend in commodity prices and export earnings[16].

### D. *Other compensatory financing schemes*

Apart from the IMF facilities, there are also compensatory payment facilities operated by the European Community for associated ACP countries, and a small scheme operated by Switzerland[17]. The principal EC scheme is STABEX, which provides compensation related to shortfalls in earnings of individual ACP countries from exports to the European Community. So far, there have been four successive STABEX schemes, each negotiated under the various Lomé Conventions linking ACP countries with the EC. Under the current Lomé IV Agreement (1991-1995), all transfers are in the form of grants, but the European Commission has an important role in deciding their use. Over the first two years of Lomé IV, the

equivalent of SDR 812 million[18], were transferred under the STABEX scheme, which covered only 35 per cent of estimated eligible export shortfalls by ACP countries. Moreover, these transfers were highly concentrated in a few countries, with four countries - Côte d'Ivoire, Cameroon, Ethiopia and Uganda - accounting for some 55 per cent of the total. Earnings shortfalls were also heavily concentrated by commodity, coffee and cocoa shortfalls accounting for over 75 per cent of the total transfers in the first two years of Lomé IV. Transfers for coffee and cocoa represented only 27 per cent of the eligible shortfalls for these two commodities, on which many of the least developed countries are highly dependent.

As is the case for the IMF facilities, the STABEX mechanism has become incapable of coping effectively with the short-term liquidity difficulties of commodity-dependent countries as a result of the sharp fall in commodity prices (particularly, the recent near-collapse of coffee and cocoa prices). STABEX was originally established "to guarantee the stabilisation of export earnings ... of products on which their [ACP] economies are dependent", but this has now become totally unrealistic in view of the low level of STABEX funding, while EC conditions on access to transfers are often related to the implementation of World Bank structural adjustment programmes. According to one expert observer, STABEX has become "more clearly an instrument for distributing donor largesse rather than a scheme for stabilizing markets with the possibility of becoming self-sustaining" (Hewitt, 1993, p. 83).

A separate EC compensatory financing scheme for mineral-dependent countries (SYSMIN) was established in 1980 (under Lomé II). Since then, loans under this scheme have totalled the equivalent of about SDR 400 million, with Zaïre and Zambia accounting for about half the total. However, there have been long delays in effecting transfers, while SDR 145 million of SYSMIN funds were transferred to STABEX in the years 1988-1990 to alleviate financial pressure on the latter. So far, no SYSMIN funds have been disbursed under Lomé IV, though commitments have been made to two countries (Namibia and Zambia). In addition, an EEC compensation scheme for the agricultural export earnings of those least developed countries which are not in the ACP group began operations in 1987. From then until the end of 1991, when the scheme appears to have ended, four countries received a total of SDR 30 million (over half going to Bangladesh).

Had the EC compensatory schemes been adequately funded, they could have played an important role in alleviating the foreign exchange squeeze on low-income and least developed African and other ACP countries which emerged in the late 1980s and early 1990s. However, the growing budgetary difficulties of the EC, combined with the effect of the downward trend in commodity prices, effectively ruled out the use of the EC compensatory financing schemes for short-term stabilization purposes. This experience, together with that of the various IMF schemes discussed earlier, strongly point to the need to combine a purely financial stabilization mechanism with export quotas and buffer stocks. The use of the latter over the period since 1988, by attenuating the fall in commodity prices, would have drastically reduced the export earnings shortfalls for which financial compensation was required. The yawning gap between shortfalls and compensatory payments would thus have been greatly narrowed or even eliminated. This is an important issue which now needs to be given serious consideration by the international community.

### *E. Risk management*

A further approach to reducing the adverse impact of commodity market instability on the economies of developing countries would be for producers to hedge their commercial risks on futures markets or on the various associated derivative markets. The main financial derivatives in use are options, swaps and commodity bonds and loans[19]. Futures markets and the market for financial derivatives have expanded rapidly over the past decade, though

very largely confined to developed countries. Futures and options contracts exist for most of the major commodities entering international trade.

The potential usefulness of these financial instruments in minimizing the risks to both sellers and purchasers of primary commodities has grown in recent years, partly as a result of the failure of the various international price-stabilization agreements discussed earlier, and partly also because many of the more important commodity exporting countries have abolished their state trading organizations, leaving the commodity export sector in the hands of small private traders. Moreover, the scope for bilateral trading agreements with reasonably stable prices between different state trading organizations has been considerably reduced, thus increasing the need for some form of hedging against the risks of unfavourable price change in the future.

However, as pointed out in a recent UNCTAD paper on the subject, the use of the financial markets for risk management by developing countries is subject to a number of limitations (UNCTAD, 1993c). First, these financial instruments do not cover the whole range of internationally traded commodities: those traded in different grades or varieties, those which cannot easily be stored, and those traded in insufficient volume, are generally not suitable for the existence of futures contracts. Moreover, where markets are characterised by a high degree of oligopoly or oligopsony, or a high degree of vertical integration, it will generally not be practicable to develop exchanges based on futures contracts. Direct trading between producer and consumer may also obviate the need for futures contracts or for the use of financial derivatives.

Second, where futures markets do exist, the costs - brokers' fees, margin calls, etc. - to exporters in developing countries may be significant, particularly if the exporting countries already have a chronic shortage of foreign exchange. Moreover, the trend away from state trading enterprises in developing countries has resulted in the emergence of small firms with little or no expertise in the use of financial markets, while brokers at commodity exchanges will normally insist on pre-payment for acting for hitherto unknown exporters. Moreover, margin calls have to be met within 24 hours in convertible currency, which could create immediate liquidity problems for the exporters in a developing country.

Third, lack of regular communication with the financial markets is a serious disadvantage to exporters in developing countries. For one thing, the specifications of a futures contract may not be quite suitable for exports from developing countries, e.g. if the futures contract specifies delivery in a developed country, but not delivery f.o.b. exporting country. Again, contract specifications may not accord with the particular types or varieties of a commodity of export interest to developing countries.

Fourth, limitations on the use of futures contracts and of the various financial derivatives, are likely to arise on the side of developed countries also if, for example, banks or trading houses in developed countries have strict limits, as seems highly probable, on exposure to perceived sovereign risk for particular developing countries. The possibility of market manipulation, causing market disruption and losses to certain market users, or the failure of some futures markets to provide reliable indicators of the future trend of prices, may well be additional limiting factors.

Fifth, most financial contracts have relatively short maturities, futures and options being usually limited to one year, though some may be written for up to a maximum of two years, which are not suitable for commodities with long lags between investment and subsequent production, such as minerals and tree products.

For these and related reasons, the use of financial instruments to reduce market risks of exporting primary commodities from developing countries must be expected to grow rather slowly over the coming decades[20]. The use of these financial instruments to reduce risk is generally incompatible with the use of international buffer

stocks (or export quotas) to reduce the amplitude of commodity price fluctuations, since where price variability is restrained the incentive for speculators to provide needed liquidity is diminished[21]. However, the fact that the use of financial derivatives by developing commodity exporting countries is growing, should not be used as an argument against the establishment of new or renewed international price-stabilization agreements. Otherwise, commodity exporting countries will continue to suffer from excessive export instability for a long time ahead, with continuing consequential difficulties for their economic development.

Finally, the alternative approaches of price-stabilization agreements and financial derivatives have quite different implications for the instability and uncertainties inherent in the world economy as a whole. While the use of financial derivatives should reduce individual risks, this by itself will not reduce commodity price instability which interacts with, and may accentuate, the fluctuations in world financial markets, and thereby exacerbate the instability of the global economy. By contrast, a system of international buffer stocks comprising all the main traded commodities, as envisaged by J.M. Keynes (1942), would act as an important stabilizing element in the international economic system.

## V. Longer-term commodity issues

In addition to the pressing problems of abnormally low levels of commodity export prices and earnings, and of continuing excessive degrees of short-term price instability for many commodity exports, most developing countries are also faced with the need to restructure their economies in ways which would lay a sound basis for sustainable economic and social development in the longer term. This is indeed a formidable task, particularly, in the present situation of continuing acute foreign exchange shortage.

Against this background, a number of issues stand out as especially important for in-depth consideration by commodity-dependent developing countries, as well as by the international community as a whole. First in importance in a long-term context is the need for diversification. This is a particularly pressing need for countries heavily dependent on commodities in structural surplus, but there is a similar need in many other developing countries also. A second, and related issue is how best to ensure that diversification, structural change and economic and social development occur in ways which are sustainable and preserve the natural environment against degradation of all kinds. Third, there is a continuing need to strive for a substantial and early reduction in the degree of price support afforded by developed countries to their agricultural producers, and to their food processing sectors, with a view to the eventual complete elimination of trade barriers to market access by low-cost producers of agricultural primary and processed products, including the developing countries. Fourth, consideration needs to be given to measures to improve the competitive position of natural raw materials produced in developing countries in relation to that of synthetic materials (produced mainly in developed countries). The following paragraphs attempt to highlight some of the main policy issues involved.

### *A. Diversification*

As a country's real income grows over time, its economy tends to become more diversified, even without specific government programmes to achieve this result. Indeed, almost all the diversification in the commodity sector that has occurred in developing countries over the postwar period has been in the larger countries which generally have more adequate economic infrastructures, higher labour and technical skills, and better access to financial sources, than have other developing countries. Small, highly specialized exporting countries, particularly those in sub-Saharan Africa, have much greater difficulties in restructuring their economies to

take advantage of potential non-traditional commodity exports, and to develop processing and manufacturing sectors.

There are, moreover, additional constraints on the possibility of diversifying into processed forms of commodities and labour-intensive manufactures for export, especially, but not only, in small and poor countries. Barriers to trade are still of major importance - even after the Uruguay Round - in limiting access to developed-country markets, transnational corporations often employ restrictive business practices limiting exports involving the use of their technology by firms in developing countries, while many processing plants - particularly those engaged in smelting and refining mineral ores, and in pulp and paper production - are very capital intensive and require the acquisition of foreign technology and know-how, as well as foreign finance, at least in part (Maizels, 1992, chapter 14). Moreover, such processing activities are not always economically undertaken in developing primary-exporting countries.

There are undoubtedly a number of measures which could be adopted by developing countries themselves, including the least diversified, such as many in sub-Saharan Africa, in order to strengthen and diversify their economies. The report of the United Nations Group of Experts on African Commodity Problems (the "Fraser Report") considered the measures that could be taken to overcome existing constraints (United Nations, 1990). The Expert Group placed Africa's commodity problems in the context of weaknesses in government policies, and in administration and organization, of insufficient priority having been given to the commodity sector in planning, budgeting, and policy formation by Governments, and of a lack of a coherent policy framework, essentially of specific measures to support a commodity strategy.

The main recommendation made by the Expert Group to overcome these weaknesses in the future was that each country should formulate its own commodity strategy, together with adequate measures to support it, within a long-term planning perspective. However, this policy prescription raises the question whether individual countries, especially small and poor ones, can in fact develop viable commodity strategies if the prices of their commodity exports remain depressed (thus depriving them of the foreign exchange that would be needed to support a proposed commodity strategy), and if their diversification plans are not compatible with possibly similar, or overlapping, plans of other countries (which would result, once again, in losses due to the fallacy of composition).

This reveals an underlying dilemma for national diversification policy, one which has also effectively undermined past international efforts to promote needed diversification in the commodity sectors of many developing countries. The problem arises because while diversification is essentially a country question, its success or failure depends heavily on movements in the world markets for the commodities involved. Policy decisions on external support for country diversification programmes have traditionally been taken (e.g. by bilateral donors, by the World Bank and the Regional Development Banks) quite separately from policy decisions affecting the international commodity markets (e.g. in GATT or UNCTAD). Some new institutional mechanism, or forum, would seem to be required to bring together the country and commodity expertise of the various international agencies concerned, so as to ensure that country programmes are devised in the context of full knowledge of the current and prospective market situation for each commodity involved, and that various country programmes are mutually consistent in the sense that, taken together, they are not likely to lead to fallacy of composition losses.

Past experience has shown that many low-income developing countries have found considerable difficulty in attracting private foreign investment, commercial banks tend to regard such countries as not creditworthy, while loans from the international financial institutions for export-oriented diversification have been concentrated on the larger, more diversified, and generally less

commodity-dependent countries. Even the African Development Bank, which has a large number of the least developed countries among its members, provided these countries, on average, with little more than one-quarter of its total loan commitments during the 1980s (UNCTAD, 1990). These, and other, low-income countries need much greater technical assistance to help them identify and formulate diversification projects which could attract greater financial support from external sources.

In addition, such countries could be assisted in their diversification efforts if they formed, or joined, regional groupings of developing countries, such as Free Trade Areas or Customs Unions. This would widen the "domestic" market and hence encourage the emergence of economies of scale and allow for greater specialization in industries or processes in which each has a comparative advantage.

Since most commodity-dependent countries are likely to remain seriously short of convertible currency for many years to come, the question arises as to whether the time has come for a much greater and more coherent international effort, than exists at present, to promote the diversification process by providing adequate external financial support.

### *B. Protecting the natural environment*

It is now widely acknowledged that economic development should be "sustainable", i.e. it should meet present needs without compromising the ability of future generations to meet their own needs. At present the global economy is far from achieving a sustainable process of development in this sense, because economic activity - especially over the past half century - has resulted in serious environmental depletion and degradation, and also because up to now national and international policies have generally not focused on the environmental problem.

Though adverse environmental impacts have arisen mainly from the industrialization process and life-styles of the presently developed countries, adverse impacts have been serious in many developing countries also, and have often arisen in the primary commodity sector of their economies, both in mining and processing of ores, and in agriculture, forestry and fishing. In all the various manifestations of environmental depletion and degradation, the underlying cause has been that market processes do not reflect environmental costs and benefits. In many cases, the hidden environmental costs in the primary commodity sector are passed on to the general population - e.g. through polluted air or water supplies - or to taxpayers, e.g. through the cost of land reclamation after mining has ended.

Since adverse environmental effects of economic activity are basically a result of market failure, Governments have the responsibility for devising mechanisms which would internalize the environmental costs involved. Such mechanisms could include imposing taxes on production of items harmful to the environment, or of removing or reducing existing subsidies on inputs (such as fertilizers or pesticides) which also have harmful effects. Equally, financial incentives for environment-friendly activities could be introduced. However, particularly where there are spillover effects, Governments will need to consider imposing quantitative limits on environmentally harmful activities.

With positive environmental policies in place, the development process should not add to existing environmental degradation; rather, environmental protection and development should be mutually reinforcing.

Environmental problems of developing countries are also closely linked with those of developed countries - in some cases through spillover effects, such as global warming - and with developed country economic policies. Several linkages are especially relevant in this context. First, it is now generally accepted that poverty in developing countries is one cause of environmental damage (e.g. to forests); poverty alleviation policies should thus help to meet

environmental goals, from which developed countries would also benefit.

Second, the real incomes of developing countries, and hence their ability to undertake environmental protection programmes, are substantially influenced by developed countries' policies. Reductions in trade barriers, for example, or policies which raise the GDP growth rate of developed countries, would therefore be likely to raise export earnings of developing countries, and would thereby also assist in financing desirable environmental protection policies. Equally, increased capital inflows, by assisting the growth of the economy, would also contribute to the attainment of environmental objectives.

A similar result could be expected from supply management schemes for commodities in structural surplus. To the extent that depressed export prices can be improved, the pressure on environmental resources is likely to be reduced. Higher prices for timber, for example, would increase the profitability of forest exploitation, and hence provide an incentive for forest preservation on a sustainable basis.

Third, developed countries have already had much experience in the use of environmental protection policies, and developing countries could usefully build on this experience in formulating their own environmental programmes. Moreover, these programmes could be greatly assisted if developing countries had easier access to the less-polluting technologies now available in developed countries.

Since developed countries would also benefit from environmental protection programmes in developing countries, they should consider contributing to the cost of such programmes, which would seem best achieved within a global context as set out in Agenda 21 of the 1992 United Nations Conference on Environment and Development (UNCED).

### *C. Reducing barriers to commodity trade*

A detailed review of the recently concluded agreement of the GATT Uruguay Round would fall outside the scope of the present paper. In any case, a quantitative assessment of the likely effects of the Round on the commodity trade of developing countries will take some time. However, a provisional assessment can be made from earlier estimates of the likely impact of the Uruguay Round on commodity trade. These estimates have been made on the basis of the main proposals under negotiation, as applied to an econometric model of the main flows of commodity trade (UNCTAD/UNDP/WIDER, 1990).

As regards the negotiations on temperate-zone agricultural products, two major proposals had been tabled by the end of 1990. One, by the United States, called for a commitment to reduce the level of domestic support by at least 75 per cent over 10 years from 1991-1992 (with a very similar proposal by the Cairns Group consisting of 14 other food-exporting countries). The second proposal, from the European Community, was for a 30 per cent reduction over 10 years from 1986 for products with an aggregate measure of support (AMS), and a 10 per cent reduction over the same period for other products. No agreement could be reached on this issue until December 1993, when it was agreed that domestic farm support would be cut by 20 per cent over a six year period, while subsidized exports would be cut by 36 per cent in value and by 21 per cent in volume.

The simulation results for temperate-zone agriculture products based on the model are summarized in the upper section of table 7, for both the United States and European Community proposals of 1990. The actual Uruguay Round agreement on this issue, mentioned above, would appear to be close to the 20 per cent cut in domestic support. The table shows the estimated effects on the value of trade[22] of the main developing regions, and of the developed countries assumed to be implementing the cuts.

A number of broad provisional conclusions

*Table 7*

**ESTIMATED EFFECTS OF ALTERNATIVE PROPOSALS IN THE GATT URUGUAY ROUND ON COMMODITY TRADE**

*($ billion, 1985-1987 prices)*

| | | Developing countries | | | |
|---|---|---|---|---|---|
| | Developed countries | Africa | Asia[a] | Latin America[b] | Total |
| 1. Selected agricultural products[c]: Reduction in domestic support by: | | | | | |
| 75 per cent | -1.86[d] | -0.97 | 0.49 | 1.96 | 1.52 |
| 30 per cent | -0.42 | -0.43 | 0.14 | 0.70 | 0.41 |
| 20 per cent | -0.25 | -0.28 | 0.06 | 0.46 | 0.24 |
| 2. Natural-resource-based products: | | | | | |
| Basic definition[e] | 0.63 | -0.03 | 0.02 | 0.17 | 0.21 |
| Extended definition[f] | 1.56 | 0.06 | 0.19 | 0.92 | 1.22 |
| 3. Tropical products[g] | 1.01 | -0.09 | 0.22 | 0.20 | 0.34 |

***Source:*** Thomas (1992).

*a* Including the Pacific.
*b* Including the Caribbean.
*c* Wheat, maize, sorghum, rice, soyabeans, soyabean oil, beef and veal, sugar.
*d* Australia, Canada, European Union, Japan and United States.
*e* Fishery and forestry products, and non-ferrous minerals and metals.
*f* Salt, sulphur, lime, cement, etc.; energy and related products; fertilizers; paper and board; and iron and steel.
*g* Tropical beverages, spices, etc., vegetable oilseeds and oils, tobacco, rice, tropical fruit and nuts, tropical wood and products, natural rubber and products, jute and hard fibres.

*Note*: For agricultural products, the figures relate to the estimated net effects on imports and exports, while for the other two commodity groups, they relate to the effects on imports into the developed countries from developing countries and on the developed countries intra-trade.

can be drawn from these results. First, it is evident that the original United States proposal of a 75 per cent support cut would have brought proportionately greater trade benefits for both developed and developing countries than will the final agreed cuts. Second, at every level of support cut, the developed countries would lose (because their food imports would rise), but they would gain far more in welfare terms by reducing costly and distorting support policies[23]. Third, among developing regions, there will be a net trade loss for Africa, mainly because on any of the support cut assumptions there will be a rise in world prices of foods, including cereals, of which many African countries are net importers.

For natural-resource-based products classified by GATT as "basic" - virtually all primary commodities - Africa would again be a net loser of foreign exchange, as a result of trade diversion, though there would be gains for Latin America (mainly in fish and timber)[24]. The "extended" definition includes some primary commodities, but in value terms it consists mainly of petroleum and manufactures.

For tropical products, the model simulations are based on the offers of tariff reductions as at end of 1990. These indicate that, once again, Africa would suffer a net trade loss, entirely attributable to trade diversion in the European Community market, where tariff reductions on an MFN basis would erode part of the demand for African products previously benefiting from GSP or ACP preferences.

The trade simulation results in table 7 are provisional and subject to later amendment, possibly substantial. Though they cannot be taken as definitive, and are in any case subject to a considerable margin of error, two broad conclusions are indicated:

(1) there is likely to be a substantial net loss in foreign exchange for the African region, partly as a result of increases in food prices and higher food import bills, and partly because of trade diversion adversely affecting African exports; and

(2) the net foreign exchange gains for the Asia-Pacific and Latin America-Caribbean regions are likely to be relatively small (some 2 or 3 per cent of the 1988 value of exports of the commodities covered).

The simulations indicate essentially the immediate and short-term static effects of the Uruguay Round on the commodity trade of developing countries. The longer-term effects are much more difficult to quantify, even on an approximate basis, but they can be taken as positive for both commodity exporters and importers. These more dynamic effects arise from the links between trade and economic growth. Reductions in trade barriers should stimulate redeployment of resources on lines of comparative advantage, leading to higher growth rates, while the latter in turn should result in higher levels of demand, and higher rates of growth in commodity trade. The question that arises is whether the dynamic gains are likely, in fact, to outweigh the negative short-term losses envisaged for Africa, and to add substantially to the relatively small short-term gains for the other developing regions. In view of the low income-elasticities of demand for many African commodities, and the difficulties of African and other low-income countries in diversifying their economies, it may well be that these countries will not, in fact, enjoy much dynamic trade benefit that may occur over the coming decade. It would therefore seem prudent for a special compensatory fund to be established to offset short-term losses suffered by low-income countries as a result of the Uruguay Round, and to retain this facility until these losses are seen to have disappeared.

If a significant proportion of external finance for diversification, discussed earlier, could be earmarked for expanding food production in food-deficit countries, this would assist in reducing, or even eliminating, short-term losses on food imports.

Finally, it would seem likely that substantial barriers to commodity exports of developing countries will still exist even after the implementation of the Uruguay Round. This provisional conclusion needs to be examined in depth on a commodity-by-commodity basis to identify the major trade barriers remaining, including those affecting processed forms of commodities.

### *D. Improving the competitive position of natural raw materials*

Developing countries heavily dependent on exports of industrial raw materials have had their market share substantially eroded ever since the 1950s by the increased use of synthetic fibres, synthetic rubber and a widening range of plastic materials. An analysis of consumption trends of natural materials in developed market-economy countries from the mid-1960s to the mid-1980s shows that the substitution of synthetic for natural materials was a major factor in the slowdown in the growth rate of consumption of natural materials over the period from the mid-1960s to the end of the 1970s. Again, in the 1980s this substitution continued at a substantial rate (table 8).

*Table 8*

**SOURCES OF CHANGE IN THE GROWTH OF CONSUMPTION OF NATURAL RAW MATERIALS, 1963-1965 TO 1984-1986**

| | 1963-1965 to 1971-1973 | 1971-1973 to 1978-1980 | 1978-1980 to 1984-1986 |
|---|---|---|---|
| | *(Growth rates, per cent per annum)* | | |
| Consumption of natural raw materials[a] | 3.2 | 0.8 | -0.4 |
| Attributable to: | | | |
| (i) Industrial growth[a] | 5.8 | 3.3 | 1.5 |
| (ii) Substitution of synthetic[b] for natural materials[c] | -2.9 | -0.9 | -1.2 |
| (iii) Change in materials-content of industrial output | 0.3 | -1.6 | -0.7 |

***Source:*** Maizels (1992), table 11.4.

*a* In the developed market-economy countries.

*b* Synthetic materials: synthetic fibres, synthetic rubber, plastic materials.

*c* Natural materials: cotton, wool, sisal, jute, rubber, non-coniferous timber, tobacco; aluminium, copper, iron ore, lead, manganese ore, nickel, tin, tungsten, zinc, and phosphate rock.

Two other major factors also contributed to this result. The first was the sharp slowdown in industrial growth in the OECD countries, which are the predominant market for synthetic as well as for natural raw materials exported by developing countries. Had the consumption of natural materials risen in proportion to industrial production, such consumption would have risen by nearly 6 per cent a year, on average, in the 1960s, but by only 3.3 per cent a year in the 1970s, reducing further to 1.5 per cent a year in the 1980s (up to 1986). Thus, the predominant factor in the decline in the growth rate of consumption of natural materials was the impact of the economic recession in the developed countries.

The second major factor has been a sharp decline in the ratio of materials usage to industrial output. This decline was particularly sharp following the large increase in oil prices in 1973/74, since efforts by manufacturing industry to economize on energy use were generally associated with increasing use of lighter materials, downsizing and waste reduction. The trend towards using less materials per unit of output continued into the 1980s, but at a lower rate than in the 1970s.

The developing countries hardest hit by the displacement of their traditional raw materials exports by synthetics have been those, such as Tanzania (sisal) and Bangladesh (jute), where consumption has been most reduced since the early 1970s. However, not all exporters of natural materials have succumbed to their displacement by synthetics. Producers of cotton and wool have retained their competitive position by technical improvements justifying their sale as quality fibres. Technical improvements and the maintenance of quality standards for natural rubber have also maintained its price competitiveness in relation to synthetic rubber.

This points to the need for a far more extensive programme of R&D and promotion, to improve the competitive position of all the major natural raw materials. Whereas for many of these

materials, global R&D into improvements in quality, in productivity and in the development of new end-uses is probably less than 1 per cent of the value of output, the corresponding percentage for the synthetics is far greater. A number of developing countries already have well-established technical research institutes for particular materials[25], and it should be possible for the relevant institutes to evolve a common R&D programme designed to improve the competitive position of their natural material, and to seek external funding to support it.

In addition, a new concern needs to be addressed, viz. the costs of repairing the environmental damage caused in the production and use of a number of synthetic materials and in the disposal of synthetic waste. As indicated earlier, these costs are not borne by the synthetic materials industries, but if they were then it seems highly likely that the competitive position of the natural materials would thereby be significantly improved.

## VI. Conclusions

The analysis and discussion in earlier sections have some important implications for international policies relating to the markets for commodity exports of developing countries, as well as for complementary international financial policies. Following the earlier discussion, these implications can be divided into those affecting short-term and long-term policies.

### *A. Short-term policies*

The main conclusion of the analysis of the short-term commodity problems of developing countries is that the key role played by the downward trend in real commodity prices in the growth in their foreign debt, their continuing foreign exchange difficulties and, indeed, in the "lost development decade" of the 1980s, should be fully recognized by the international community. This would bring the issue of how best to deal with persistently depressed levels of prices for a range of important commodities back on the international agenda for effective remedial policies. For almost a decade now, there have been international efforts to evolve an effective policy for dealing with the huge debt problem of many developing countries, whereas the underlying problem of growing structural surpluses in the markets for many important commodities has been virtually a taboo issue.

There is little doubt that the organization of commodity markets in the global economy remains seriously inefficient and inequitable. The inefficiency arises mainly from the high level of government intervention which introduces massive misallocation of global resources, particularly in agriculture. The inequity arises since the (non-mineral) commodity producers in developed countries generally enjoy relatively stable and profitable prices for their output, while the corresponding producers in most developing countries have to cope with unstable prices, often at depressed levels, both the instability and the depressed levels being, for some commodities, a consequence of the protected markets in developed countries.

There are several implications for the development of an effective remedial strategy in this area, which have been brought out in previous sections. To summarize briefly, these are:

(1) For commodities in *structural surplus*, some form of supply management is needed to raise depressed levels of prices to more remunerative levels, while taking the interests of consumers into account. Supply management should be accompanied by programmes for diversification of production away from such commodities, preferably in high-cost producing countries. Supply management arrangements should, where possible, be negotiated and implemented within the framework of producer-consumer agreements; if this is not possible, producer-only accords should be considered.

(2) For commodities subject to *high levels of short-term price instability*, renewed efforts are needed to negotiate price-stabilization agreements based on buffer stocks, supported where necessary by export quotas. Any new agreements would need to be greatly improved, compared with past ones, particularly in the provision of adequate financing, greater flexibility in operation, and assurance that they would be supported, and not undermined, by policies of national Governments. It would also be essential for agreement to be reached between producers and consumers that the price range to be defended should reflect market trends.

The existing international *compensatory finance* facilities are inadequate, and need to be greatly expanded on the basis of low conditionality and a low rate of interest for low-income countries. The need for compensation of export shortfalls would be reduced substantially to the extent that price-stabilization agreements could be successfully negotiated.

The use of the markets for *financial derivatives* would assist exporters in developing countries in reducing their commercial risks, but there are major limitations to the widespread use of these markets by developing countries, at least for many years to come. In any case, the reduction of risk by individual exporters cannot be expected to reduce significantly the instability of the commodity markets themselves.

### *B. Long-term policies*

*(1) Diversification*

For countries heavily dependent on export of commodities in structural surplus, the international community should support appropriate diversification. This might best be achieved through some new institutional mechanism or forum, which would assemble and analyse trends in the world market for a wide range of raw and processed commodities, review existing diversification programmes and their probable impact on world markets, and advise individual countries on how they might best diversify their economies.

There should be an expanded programme of financial and technical assistance for low-income countries which need to diversify, to help them to identify and formulate diversification projects which could attract greater financial support from external sources.

The international financial institutions should not advance loans for expanded production of commodities now, or likely to become, in structural surplus. The IMF should reconsider its emphasis on expanding exports in the case of countries dependent on commodities in structural surplus where there is a likelihood of "fallacy of composition" effects.

*(2) Environmental protection*

Developing countries should consider how best to internalize the environmental costs and benefits of commodity production and waste disposal. They also need to impose quantitative limits on environmentally-harmful activities, especially where there are significant spillover effects.

Developed countries should provide effective support for environmental protection programmes of developing countries, including contributing to the costs involved, within the framework of Agenda 21 of UNCED.

*(3) Reducing protectionist barriers*

A special international Fund should be established to compensate those countries -mainly in Africa - which suffer a net income loss as a result of the GATT Uruguay Round agreement.

Since the results of the Round will provide relatively large benefits for developed countries, but relatively small benefits for the majority of developing countries, further efforts are needed to negotiate possibly in a new mini-round substantial reductions in the remaining barriers to exports of

raw and processed commodities from developing countries.

*(4) Improving the competitive position of natural raw materials*

A much larger programme of research and development, and of promotion, than at present, is needed to improve the competitive position of the major natural raw materials exported by developing countries. A first useful step in this direction would be for the relevant national technical research institutes to evolve a common R&D programme to improve productivity, improve the technical characteristics and develop new end-uses of each major raw material, and to seek external funding for it.

A study of the environmental costs and benefits of producing and consuming natural raw materials, and of disposals of their waste products, should be made in relation to the corresponding costs and benefits for competing synthetic materials.

***C. The trend towards market-oriented approaches to commodity policy***

Over the past decade there has been a widespread trend among developing countries to abandon state control or regulation of economic activities in favour of market-related mechanisms to achieve national economic goals. A similar trend can be discerned in international commodity policy, with the collapse or lapsing of the previously operative commodity agreements and a new emphasis on market-oriented approaches to commodity problems (UNCTAD, 1992).

While this trend will undoubtedly have beneficial effects in some respects there may, however, be harmful effects in others. If the central commodity problem facing developing countries is the persistence of abnormally low real commodity prices, an emphasis on a market-oriented approach would indeed bring a "solution" in the long term, but market balance would be achieved in many cases only by a massive contraction in commodity output with further sharp reductions in living standards and investment in physical assets and human resources development. Thus, market solutions to this central problem are likely to keep the economies of commodity-dependent countries, particularly the smaller and poorer ones, in a weak condition, thus adding a further deflationary element in the world economy.

The argument in favour of seeking market-oriented approaches is, indeed, an over-simplification since it implicitly assumes that all state intervention is harmful, while all markets behave as if they are based on perfect competition. In fact, while some state intervention is harmful (e.g. barriers to trade), other intervention is beneficial (e.g. regulation of polluting industries). Moreover, while some commodity markets operate essentially on a fully competitive basis, many others are heavily distorted by government intervention, are dominated by vertical integration or are subject to oligopoly or oligopsony forces which contradict the assumptions of "perfect competition".

Thus, international commodity policy, to be effective in promoting the development process, must comprise a balanced package of measures specifically adapted to the particular problems to be dealt with. Policy relying solely on a market-oriented approach would be one-sided, and would not by itself provide an acceptable solution to the central commodity problem.

As regards excessive short-term commodity price instability, a market-oriented approach (operations on the futures and financial derivatives markets) would again not produce an acceptable solution, at least in the short - and medium - terms, for reasons set out earlier. Rather, a combination of this approach with market intervention by buffer stock operations (backed where necessary by export quotas) would appear the preferable approach.

Finally, an assessment of the merits of a market-oriented approach needs to consider the interdependence between the international

commodity markets and the financial markets. Over the past decade, the financial markets have exhibited greater instability, and an increased predominance of speculative activities, which has also spilled over into the commodity terminal markets. Large amounts of speculative funds can be switched into, and out of, the commodity markets in periods of heightened uncertainty about the future trends of commodity prices, or of inflation and exchange rates, thereby accentuating the movement in commodity prices, which, in turn, tends to attract more speculative funds. Large swings in commodity prices may also affect domestic monetary policy in developed countries, via their effect on import costs, so that the interactions between commodity and financial markets is likely generally to increase the instability of the global economy under a market-oriented system with a large and growing speculative component. Increased instability and uncertainty about the future course of the global economy is, in turn, likely to inhibit investment in longer-term productive capacity and, to this extent, to limit the potential growth of the international economic system.

## *Notes*

1 In this paper, the term "primary commodities" or "commodities" excludes petroleum.

2 "Real commodity prices" or "the commodity terms of trade" denote nominal commodity prices deflated by an index of the unit value of manufactures exported by developed countries.

3 This analysis is based largely on the results of a number of econometric studies, in particular, Englander (1985), Hartman (1985), Chu and Morrison (1986), Morrison and Wattleworth (1988), and Gilbert (1989).

4 Since 1980, the per capita consumption of meat and sugar, in particular, as well as tobacco, has fallen significantly, while only marginal increases have occurred in per capita consumption of many other foods and beverages.

5 A cross-country regression analysis by Gilbert (1989) indicated that efforts by individual countries to meet debt service obligations have reduced export earnings for all commodity producers, thus making it more difficult for them as a group to meet their obligations. This is an important policy issue which requires in-depth quantitative research on a commodity/country basis.

6 The effect of change in the commodity terms of trade (CTT) on export earnings is defined as:

$$\Delta CTT = \sum_{i=1}^{n} \left( Vx_{il} \left( \frac{1}{Pm_i} - \frac{1}{Px_i} \right) \right)$$

where $Vx_{il}$ relates to the value of exports of commodity i in a later year, and $Pm_i$ and $Px_i$ are, respectively, indices of (commodity) export unit value and of (manufactures) import unit value, with base year (1980) unit values = 1.

Though 1980 was a peak year for commodity prices in nominal terms, in terms of real commodity prices it was not a peak year. Real commodity prices in 1980 were, in fact, the same as the average for 1975-1979 if the peak year (1977) is excluded.

7 For details, see Maizels (1992), Appendix.

8 See Helleiner (1986) for an analysis of this effect in the context of African economic growth.

9 For a recent review of the literature on the effects of export instability on economic growth, see Maizels (1992), chapter 4.

10 An exception was the 1986 bilateral agreement, now defunct, between Grenada and Indonesia to enforce minimum prices for exports of nutmeg and mace.

11 For such reviews see, in particular, Gordon-Ashworth (1984), Gilbert (1989) and Maizels (1992).

12 Including unrealistic price ranges, expanding exports from non-member countries, and inadequate financing of a buffer stock.

13 The argument at this point relates solely to the aim of reducing excessive short-term price fluctuations. Of course, if the declared objective was to raise the level (or trend) of prices, this would itself provide an incentive to reduce productive capacity, or at least not to increase it, since producers would then expect export quotas to last for a period of years.

14 A preliminary analysis of this issue (Labys and Maizels, 1993) showed a much stronger relationship than had been anticipated between non-oil commodity prices and domestic prices, costs, and other economic variables in the main developed countries, with a particularly strong relationship between commodity prices and industrial share prices.

15 These comparisons between drawings and shortfalls are not strictly accurate in so far as drawings are related, inter alia, to the IMF definition of shortfall which uses a 5-year geometric average of export earnings centred on the shortfall year as the reference level, whereas the UNCTAD measure uses a 4-year moving arithmetic average ending in the preceding year as the reference. However, this definitional difference cannot affect the broad conclusion relating to the overall inadequacy of IMF compensatory finance available.

16 The detailed results of the UNCTAD calculations indicate that there is a significant positive association between the magnitude of shortfalls for individual commodities and the trend in their prices on the world market.

17 The Swiss scheme, which covers a list of agricultural exports to Switzerland, is not discussed further in this paper. Total transfers over the period 1988-1992 were SDR 46 million to a number of least developed countries.

18 STABEX transfers are made in ECU (the total in 1991 and 1992 amounted to ECU 877 million.)

19 Options, like futures contracts, protect buyers of these contracts against unfavourable price movements, but also allow the possibility of taking a profit from favourable price changes. A swap agreement covers a specified quantity of a commodity, but includes two prices, viz. a price fixed at the date of the agreement, and a variable price (such as the price of a futures contract). Producers sell their commodities on the physical market, but under the swap they are compensated for (or pay) amounts related to the difference between the two prices, so that swaps are, in effect, long-term hedges. Commodity bonds and loans are usually linked to investment projects or debt reschedulings in order to raise capital on favourable terms.

20 The World Bank began a technical assistance programme in 1990 to help developing countries to utilize commodity-linked financial instruments in order to reduce their commodity price risk. So far, most of this assistance has been to Latin American countries.

21 For example, when the first International Coffee Agreement came into force (1962), the number of coffee futures contracts traded on the New York terminal market fell off sharply.

22 The model results also include the corresponding changes in welfare (defined as the sum of changes in producer and consumer surpluses, plus the change in government revenue), though these are not reproduced here.

23 The welfare benefits to the developed countries assumed to be implementing the cuts in farm support range from $5.7 billion for the 20 per cent cut, to $8.2 billion for 30 per cent and $18.3 billion for 75 per cent cuts (Thomas, 1992, table 5).

24 The estimated trade effects for this group of products are based on the proposals of the Chairman of the Negotiating Group on Natural Resource-Based Products (November 1990), namely zero tariff on raw materials, elimination of all tariffs of 2 per cent or less, and reductions in all other tariffs according to a formula.

25 For example, the Rubber Research Institute in Malaysia, and the Leather Research Institute in India.

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# EFFECTIVE USE OF FINANCIAL MARKETS FOR RISK MANAGEMENT BY DEVELOPING COUNTRIES: A POLICY OVERVIEW

**Donald R. Lessard**


## *Abstract*

*A variety of factors contribute to an increased "demand" for risk management by developing countries. The global economy continues to display a high level of volatility; efforts to stabilize exchange rates, interest rates and commodity prices appear to have failed; and developing countries are increasingly exposed to this global volatility as they become more integrated into the world economy.*

*Moreover, the developing economies themselves continue to display high degrees of volatility, not only as the result of external shocks, but also because of swings in confidence, shifts in policy, and other internal shocks. This volatility, coupled with typically high levels of indebtedness and low levels of international reserves, make these nations vulnerable to payments crises which, in turn, reduce their credibility and ability to obtain external finance for investment or stabilization purposes.*

*Developing countries face many obstacles in risk management. First, awareness and understanding of risk exposures in these countries are relatively weak; secondly, it is difficult to identify and measure risk exposures; thirdly, their access to international financial markets is limited owing to lack of creditworthiness; fourthly, few developing countries' regulatory systems can keep up with the rapid pace of change in international financial markets.*

*Developing countries should have an overall risk-management strategy that involves the assessment of risk exposures at various levels of the economy. At the highest level, this must include the central bank, treasury and key foreign exchange generators. In terms of institutional oversight, it must also include those entities responsible for the oversight of banks and other financial institutions, securities markets and corporations, as well as ministries concerned with specific sectors with significant risk exposure.*

*Only a small fraction of the potential diversification of risk can be accomplished within national boundaries; therefore, risk management will involve transactions with external financial centres which, in turn, require the adaptation of institutions and regulations to enable links to external markets.*

*The World Bank and other institutions should expand their "one price" lending to include denominating borrowers' obligations in any basket of major currencies. The international financial institutions should also facilitate additional risk shifting transactions where required and provide or facilitate contingent financing tied to the performance of specific projects or commodity prices in cases where projects have significant external risk exposures.*

## Introduction

Risk management will be a central issue for developing countries in the remainder of the 1990s for several reasons. First, the current structure of the global economy - with no clear hegemonic leader, but with increased real integration and interdependence, limited coordination in macroeconomic policies among major countries, and decreasing effectiveness of the traditional tools of macroeconomic management - will give rise to continued volatility in many of the key parameters of the global economy, including interest rates, exchange rates and commodity prices.

Secondly, as developing countries themselves become more open both in commercial and financial terms, they will become more exposed to this volatility. As many of them become more specialized as they seek efficiency within the world division of labor, this exposure will be heightened. As their finances become more integrated into the world economy, they will also be subject to the impact of volatility in world financial markets on their external assets and liabilities.

Thirdly, as a result of this increasing interdependence and resulting exposure to volatility, as well as to a variety of structural issues, third world economies will remain highly risky, in themselves, with variations in confidence and capital flows. Many will experience financial difficulties and country creditworthiness will continue to be an issue.

Fourthly, many new technologies for financial risk management have been developed and are now generally available in financial markets. Developing country Governments can now take advantage of many of these tools for their own purposes.

Fifthly, the role of developing country Governments in their own economies is rapidly changing; in most cases their direct role is shrinking while their role as providers of critical physical and institutional infrastructures is increasing. With respect to external commercial and financial transactions, this involves a shift from intermediating most transactions with the rest of the world to one of providing the financial and contractual infrastructure within which autonomous entities may transact directly with the rest of the world. As autonomous players become more active internationally, the implicit as opposed to the direct risk exposures of the State will become more important.

In recent years, international financial institutions (IFIs), especially the World Bank and the International Finance Corporation (IFC), but also the European Development Bank and the various regional development banks have developed normative approaches for risk management by developing countries; they have engaged in training and technical assistance missions in this regard and are beginning to provide policy advice along these lines, and in some limited cases they have actually entered into risk-shifting transactions with developing countries or have helped to structure such transactions on behalf of developing countries. Further, private providers of financial services have urged risk-management tools and transactions on developing countries. Finally, many developing countries themselves have acquired risk-management capabilities, both in the public and private sectors, in part as the result of the dispersion of financial talent with the collapse of money centre banks in New York in the 1980s.

This report seeks to outline the key elements of risk-management and assess in broad terms the policy recommendations to developing countries made by international institutions regarding risk-management programmes. It defines risk management both broadly and narrowly; broadly in the sense of all mechanisms, structural as well as financial, that can be employed to alter the risk profiles of the State and of specific enterprises or sectors within the economy. However, its primary focus is on risk management more narrowly defined - the use of financial risk-management tools such as futures, options and other derivative products to alter these risk profiles.

It focuses on several questions that face

policy-makers with regard to risk management:

- What is risk management?
- Should developing countries engage in risk management?
- Whose risk should they manage?
- What risks should they manage?
- How should they manage these risks?
- How should they organize risk management?
- What should IFIs do to support risk management by developing countries?

The report does not seek to provide a detailed description of specific risk-management techniques, as these are well described in recent World Bank and IFC publications (Claessens, 1993; Glen, 1993) which should be read together with this report. Part I provides an overview and a detailed description of the stages of risk management. Part II identifies sources of risks, including exogenous risks from the viewpoint of developing countries - those market and systematic risks that are totally outside of the control of developing countries, and endogenous risks - those risks that are created or at least amplified within the domestic economy. It also explores the incidence of these risks in the economy at various levels. Part III develops the concept of comparative advantage in risk bearing and draws implications for the desired degree of risk pooling within individual developing countries and risk shifting between these countries and others in the world economy. Part IV examines mechanisms for risk management, concentrating on commodity price risk exposures. Part V concludes by emphasizing the steps that should be taken by developing countries and IFIs to facilitate effective risk management.

## I. What is risk management?

Risk management is the discipline of identifying risks in the environment, assessing their potential impact on critical variables, and employing direct and indirect mechanisms for either altering the exposure of underlying economic activities to these risks or shifting some of the exposure to others.

Risk management can take many forms, both structural and financial. The most basic structural form of risk management is diversification of real activities - not putting all of one's eggs into one basket; holding stocks of goods consumed even in periods of low output or income.

Financial mechanisms involve the structuring of claims within or between countries in order to shift income across circumstances. One financial mechanism is to hold financial reserves - claims that can be traded for real goods on a "rainy day." Another is to enter into contracts to fix the future price of some key output or input, such as oil or wheat prices. Often, risk management is bundled with financing. A farmer borrowing money to pay the costs of planting a crop may have a choice of repaying a fixed amount or repaying a share of the crop. By denominating the obligation in terms of a fixed physical quantity, the farmer shifts the risk of price fluctuations to the lender. By denominating it as a share of output, he also shifts output risks.

Alternatively, the farmer might undertake financing and risk management separately, by borrowing from a bank on terms that are independent of the price or quantity of the crop, but by locking in the price of the crop in futures markets, thereby shifting the risk of price fluctuations to others.

Most recent developments in risk-management technologies and markets have involved the development of pure risk shifting contracts that can be separated from financing. While forward transactions which allow pre-contracting for commodity prices and currency exchange rates have existed for centuries, formal futures markets that provide open access to such transactions with few or no preconditions on the creditworthiness of participants have burgeoned since the 1980s. Swaps, which are similar to forwards but extend over longer periods and also reduce direct exposures, are also relatively new. Options,

which provide the right but not the obligation to buy or sell a currency, commodity or financial asset for a particular price have existed for decades, but the range of assets covered and the depth of markets have increased dramatically following the development of explicit methods for pricing and hedging such instruments in the 1970s. Thus, in principle at least, a broad array of instruments for managing risk exists; many of these instruments are actively traded in transparent competitive markets that should assure fair pricing over time.

For a developing country, risk management can be applied at several levels to solve different problems. From the perspective of the State and its agencies, risk management can be used to stabilize government receipts, external debt service or to eliminate spikes in debt service associated with events elsewhere in the world. Alternatively, it might be used to smooth net foreign exchange earnings in the face of fluctuations resulting from shifting commodity prices or swings in economic activity in other countries.

Firms or banks in developing countries can apply risk management to reduce fluctuations in their operating cash flows and net worth resulting from marketable dimensions of risk, whether local or foreign. Farmers, either directly or indirectly through local intermediaries, can employ risk-management to protect themselves against drops in crop prices. Finally, households, as investors in pension funds and other contractual savings vehicles, might indirectly employ risk-management techniques to shift some of the risks inherent in their own economies to others.

Risk management involves a number of stages (box 1). Each is briefly described below.

***Specify objects of risk management.*** The first stage of risk management is to specify the objects of risk management - the performance measures whose volatility the risk manager is seeking to limit. Many objects are possible, depending ultimately on whose risks are to be managed, those of the nation as a whole, those of the central Government, those of one sector, agency, or enterprise, or those of one project, etc. Most important for central Government will be the performance measures for which it is directly responsible - elements of the budget and net foreign settlements. However, since these objects typically will be exposed to many risks, an assessment may choose to focus on some subset of the total object for which exposures and risk management transactions can be more readily defined. An example would be the oil revenues for a country such as Venezuela or Nigeria, or debt service for highly indebted countries.

For a state-owned or private enterprise, the object will be operating cash flow, defined as the cash flows generated from current operations, and net free cash flow, defined as the operating cash flow less financial commitments such as debt service and capital outlays that it must make in order to meet commitments and/or maintain viability. For a production sector, it might be the price of a key commodity output or input.

For a pension fund, it will be the value of its assets, ideally measured in terms that reflect the composition of consumption of its intended beneficiaries. For a social or demographic group, it might be some collection of factors that have a dominant impact on income flows.

***Identify key risk dimensions and exposures.*** While many risk factors influence the object(s) of risk management, the primary focus should be on those factors which can be managed via financial market transactions. At the present time, these are primarily exchange rates, interest rates, and prices of key commodities. Preconditions for the existence of deep markets for risk shifting are that many different entities have exposures to these risks on both sides, e.g. both users and producers of a commodity, and that no single party is in a position to dictate outcomes. Indirectly, there are markets for other more aggregate risk variables. Shares of Telmex, for example, provide quite a good way to "bet on" or "hedge" against the overall risks associated with the Mexican economy.

Assessment of exposures typically involves both structural and statistical analysis. Structural

**Box 1**

## STAGES IN RISK MANAGEMENT[1]

(a) Identify the measure(s) of performance to be managed, e.g. net foreign exchange settlements, budget surplus/deficit, discretionary government resources, national income, etc.;

(b) Identify and assess the sensitivity of these measures of performance to external risk sources such as fluctuations in exchange rates, interest rates and commodity prices;

(c) Assess how the exposures to various risk sources interact to determine the overall risk associated with the performance measures selected;

(d) Determine an acceptable degree of risk for the performance measure in question; and

(e) Bring risks in line with this goal by altering the structure of external obligations and assets, modifying the structure of real economic activity, or by executing specific risk-hedging transactions.

1 This definition is adapted from Claessens (1993).

analysis involves examining the forces that shape demand, supply and prices. Statistical analysis involves testing and confirmation of these relationships from past experience. Both are difficult since it is hard to isolate effects. However, formal analysis is required since seemingly common-sense solutions may be incorrect. For example, it might appear appropriate for a country exporting copper to denominate its obligations in dollars, since copper prices are quoted in dollars. However, research has shown that the dollar price of copper is sensitive to the level of the dollar vis-à-vis the yen and the DM and, therefore, a basket of currencies would actually provide a better match (Dumas and Jorion, 1993; Dornbusch, 1987).

***Estimate risk profiles.*** Once exposures of particular risk-management objects to specified risk dimensions are identified, it is possible to estimate the risk profiles of these objects. These risk profiles can be expressed in many different ways, such as the volatility (standard deviation) or potential range of the performance measure, or the probability that its value will fall below some threshold level within a specified time frame.

The principal object at this stage is to identify those exposures that appear to give rise to excessive risks for various performance measures. It is important to know whether the potential variation in an external risk variable, such as a commodity price, is likely to result in changes in net exports or government revenues of plus or minus 5 per cent or plus or minus 50 per cent. A useful rule of thumb is to focus on those risk dimensions where the historical range of variations can be expected to produce fluctuations of plus or minus 10 per cent or more in critical performance measures.

***Determine target risk profile.*** Given the risk profiles of various performance measures it is necessary to define the desired or target profiles as guides to actual risk-management transactions. Determining this desired profile, however, typically requires iteration with the subsequent stage - identifying cost-effective risk-shifting

transactions, since it is in general impossible to define a desired risk profile without knowing the cost of modifying it. Other things being equal, less risk is preferable to more risk, but usually in order to reduce risk, a country will incur costs in the form of lower revenues or higher costs on average over time and across circumstances. Thus it must assess the tradeoff between the average level of the performance measure in question and the risk associated with that measure.

***Select mechanisms for risk management.*** Once actual and target risk profiles are identified, alternative mechanisms for risk reduction can be considered. In most cases, several different types of financial instruments will exist that shape risk profiles differently, and which may be traded with different degrees of efficiency. An oil forward or futures contract, for example, will lock in the price for a portion of a country's oil exports (imports). The price of risk reduction with a forward contract, in addition to the direct transaction costs involved, will be the "opportunity loss" of having to sell at that price under circumstances where prices are higher. The benefit, of course, will be to sell at that price when actual spot prices are lower. With a standard option, in contrast, the price of risk reduction will be in the form of a cash premium that must be paid at the outset. Range options combine some features of both forwards and options, placing a floor on prices at the cost of imposing an upper limit on realized prices as well. Thus the price of risk reduction is the opportunity loss in particular future circumstances where prices are very high.

Risk management can also be bundled with financing and management services. If the country wishes to link risk management to financing, it may want to consider issuing oil-price linked bonds. If it wants to bring in foreign technical expertise as well, it may choose to exploit its reserves through production sharing or other risk sharing mechanisms, which give outsiders a voice in strategic and operating decisions along with their participation in income.

***Execute specific risk-management transactions.*** Actual risk-management transactions, such as selling commodity forwards, purchasing put options to create floors on commodity price receipts, or swapping future commodity deliveries for fixed or price-level indexed monetary amounts will be performed by operational units within the various agencies. The key policy issues are to define the parameters within which these units should operate. These include: the target or benchmark risk profiles, the range of discretion allowed the unit relative to these target profiles, and the way the unit's effectiveness will be measured.

***Track effectiveness of risk management.*** The final stage in risk management is tracking the effectiveness of the risk-management unit relative to the target profiles within the guidelines provided.

## II. Sources and incidence of risk exposures

The risk exposures of developing countries are many and varied. The treasury and state agencies are directly exposed to fluctuations in commodity prices, interest rates, exchange rates, and levels of economic activity through their net international settlements on commercial accounts and their financial settlements with the rest of the world. Moreover, they are indirectly exposed to a host of risks faced by local households, firms and financial intermediaries through their tax receipts as well as through committed expenditures, the levels of which depend on some of these same factors. These exposures matter to the State not only because in aggregate they form overall national exposures, but because certain exposures, if sufficiently concentrated in particular sectors or institutions, may have systemic impacts beyond the direct losses involved and/or may result in pressures that will require the "socialization" of these losses.

Table 1 identifies the typical exposures of a developing country at different levels. In addition to these external risks, the State, firms and households will also be exposed to fluctuations in domestic economic activity, prices and interest

***Table 1***

**SOURCES OF EXTERNAL RISK EXPOSURES**

| Risk dimension / level | Commodity prices | Interest rates [a] | Exchange rates | Economic activity |
|---|---|---|---|---|
| Primary exports | X | | ? | X |
| Manufactured exports | | ? | X | X |
| Tourism receipts | | X | X | X |
| Energy imports | X | | ? | |
| Debt service | | X | X | |
| Manufactured imports | | | X | |
| Assets / liabilities of banks | | X | X | |
| Operating cash flows / liabilities of major enterprises | X | X | X | X |
| Earnings of key sectors, e.g. farmers, miners | X | | | X |
| Operating income of firms in general | X | X | X | X |
| Asset values of pension funds | | X | X | |
| Income, wealth of households in general | | X | X | |

*a* Also includes share prices and other financial asset prices.

rates. While to some extent these fluctuations reflect external shocks, they differ in that many of them involve a dimension of policy or choice on the part of developing country actors. Therefore, they are not purely insurable in a classic sense. Nevertheless, they should be taken into account in overall risk management.

A key question in risk management for a developing country is to define whose risk is to be managed. For a developing country, many answers are possible, and often more than one is correct. From the viewpoint of an idealized, omniscient planner, the principal concern should be the risk to the nation as a whole, the potential volatility of aggregate national income net of foreign transfers and debt service. Even this planner, though, will be concerned with differences in risk exposures within the national economy given that fiscal interventions are not costless.

In the real world, however, there will be a multiplicity of institutions, interests and households, each with their own exposures. The central bank will be directly concerned with the exposures of its foreign currency reserves as well as short-term projected foreign exchange inflows and outflows, not to mention indirectly with the full structure of foreign claims and other factors that could give rise to shifts in foreign exchange movements, as well as to the exposures of financial institutions whose failure would threaten the stability of the financial system for which it is responsible. The State as fiscal authority will be concerned with the exposures implicit in its projected tax revenues, in its internal and external obligations, and in its implicit obligations not only in the form of social entitlements, as also as "backstop" to domestic firms and financial

institutions should they encounter difficulties that threaten the State's economic or distributional objectives. Thus, monetary and fiscal authorities will be concerned not only with their own exposures, but with those of any entity sufficiently large to be a "squeaky wheel' in the case of failure and, thereby, effectively force a bail-out.

The State as manager and regulator of retirement schemes will be concerned with the exposures of asset values relative to implied liabilities, not only for direct state programmes but also for the full set of programmes that involve implicit liabilities of the State in case of failure at any level. Enterprises, whether publicly or privately owned, will be concerned with the exposures of their cash flows over time. Banks and other financial institutions will focus on their net asset values. Their degree of concern, of course, will depend on how much implicit backing they expect in the case of failure.

## III. Comparative advantage in risk bearing

Just as ideal patterns of specialization and trade among countries can be defined in terms of comparative advantage, ideal patterns of financing and risk bearing within and across countries can be defined in terms of financial comparative advantage.

The comparative advantage of specific actors in bearing particular types of risks depends on three factors:

(a) the extent to which they can diversify the risk;

(b) the extent to which they have superior information regarding outcomes; and

(c) the extent to which they can mitigate the risks.

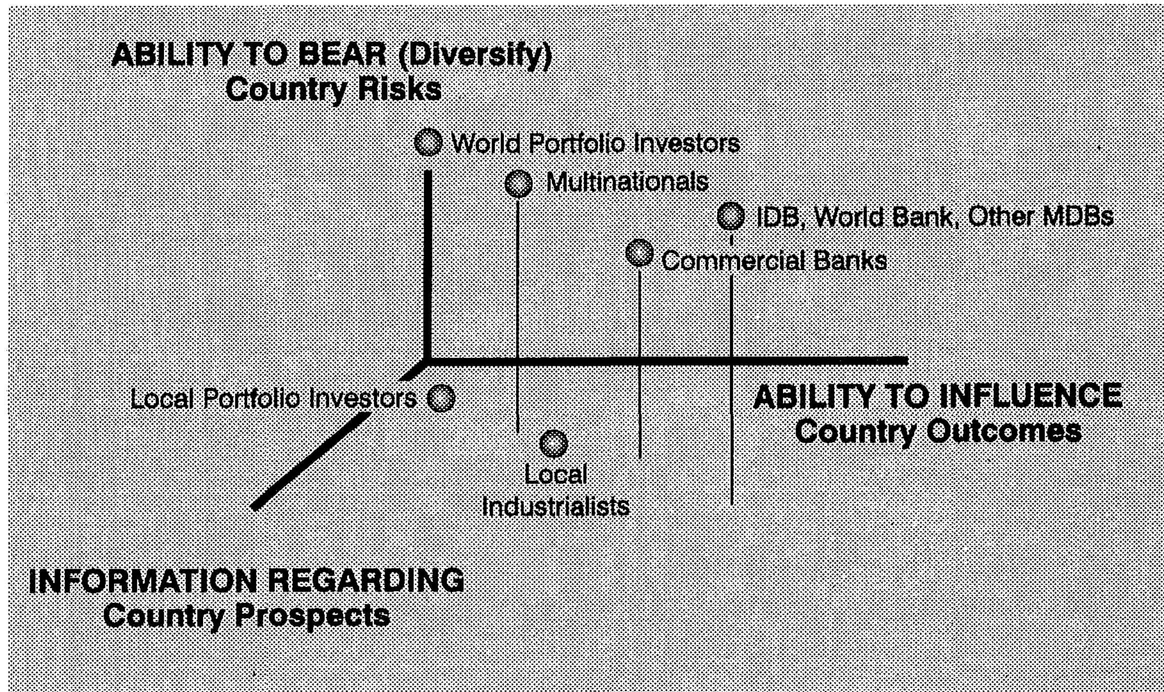
For "marketable" risks, such as commodity prices, interest rates and exchange rates of major currencies, where information is widely available and there are many players, the major determinant of comparative advantage is the ability to diversify risk. An oil-exporting country, for example, that depends on oil revenues for a large fraction of its foreign exchange earnings and government revenues, would be at a comparative disadvantage in bearing (long) oil price risk relative to the world markets at large. Similarly, a country entirely dependent on oil imports would be at a comparative disadvantage in bearing (short) oil price risk.

Commercial undertakings typically involve a mixture of exogenous, "marketable" risks and risks associated with national policy and context and firm-level actions, risks for which certain actors possess special information and/or influence. Consider oil field exploration and development. Here, the major risks can be grouped into four categories: (a) those associated with geology, and in the case that a commercial field is discovered, (b) those associated with both capital and operating costs, (c) those resulting from variations in oil prices and (d) finally variations in the "take" of the host Government. By applying the same rules regarding comparative advantage in risk-bearing it is possible to identify which agents have a comparative advantage in bearing each of these risks.

With respect to geological risk, while the underlying risk structure is totally beyond the control of the participants, information regarding that risk is the major factor creating comparative advantage. For "old" geological areas where information is fairly widely available and standard forms of analysis are applicable, both local and foreign firms will be on an equal footing. In contrast, in new areas, involving complex structures, etc., particular firms, typically multinationals with experience and special skills, will have the comparative advantage. This shows why it is often in countries' interests to seek public funding for exploration activities whose results are then made generally available.

*Figure 1*

**COMPARATIVE ADVANTAGE IN RISK BEARING: COUNTRY-LEVEL RISKS**




Capital and operating costs, in contrast, are at least partially under the control of the operating company. Therefore, these risks are best borne by the company that incurs them. If they are contracted for on a cost-plus basis, for example, the principal, e.g. the state oil company in the developing country, must monitor expenditures closely to see that it is not overcharged.

In the case of oil price risks, comparative advantage depends on the circumstances of the country in question. A country such as Brazil has a comparative advantage in bearing (long) oil price since it is a net importer. In contrast, countries such as Venezuela and Nigeria, highly dependent on oil exports, are at a strong comparative disadvantage in bearing oil price risk.

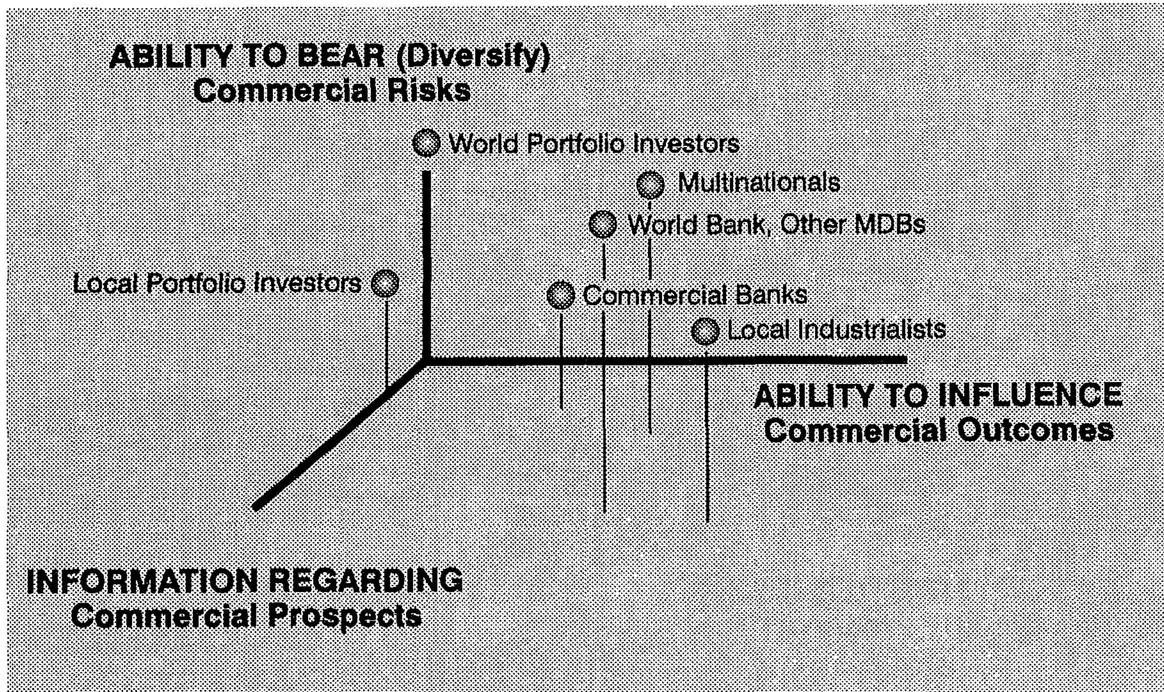
The upshot of this analysis is that there is no single appropriate contracting structure for oil exploration development. It depends upon the distribution of information and expertise among actors, the capability of the Government to both specify and monitor activity, and ultimately the risk exposure of the country in question in the face of oil prices.[1] A key contribution of risk-management technology is to allow the bundling or unbundling of various risk in order to align risk exposures with the ability to bear them.

Generalizing, it is interesting to consider which agents have comparative advantage in bearing country-level risks, e.g. the risks associated with the country's overall economic performance as well as the country transfer, sovereign and political risks associated with all (most) activities undertaken in the country, and compare this with the comparative advantage of the same agents in bearing commercial risks at the project or enterprise level.

Figure 1 depicts comparative advantage in bearing country-level risks. World portfolio investors have a strong advantage in terms of their ability to diversify country risks since the typical developing country represents a trivial portion of

*Figure 2*

**COMPARATIVE ADVANTAGE IN RISK BEARING: PROJECT-LEVEL RISKS**




their portfolio. However, they have no information regarding country prospects, no ability to influence country outcomes, and little incentive to seek to overcome these disadvantages given the small scale of developing country opportunities. Therefore, on their own, they typically will not participate in developing country finance.[2]

Multinational firms have substantial information regarding country prospects and some ability to influence country outcomes, and also considerable ability to bear country risk. Therefore, they have a significant comparative advantage. Local industrialists, in contrast, typically have considerable information regarding countries' prospects, and as stakeholders in the political system, they are able to exert considerable influence over country outcomes. However, they have extreme exposures to country risk since much of their human capital is home-country specific, and because of these informational and influence advantages, they will have concentrated their portfolios in home-country undertakings. This makes clear that the parties most exposed to country risk in all of its forms are the locals, not the foreigners, and perhaps the whole discussion over country risk insurance should be turned on its head.

International banks have substantial information and influence, but they have portfolios that are quite skewed toward developing country debts. The World Bank and other regional development banks are in a somewhat similar position, typically with greater leverage because of the extensive cross-default clauses and other linkages to official actions, and also with broader diversification. Although their portfolios are concentrated in the obligations of less developed countries, the sponsor Governments that stand behind them are, in fact, well diversified.

What is interesting to note is that three sets of large-scale institutions capable of generating

information, exerting leverage and diversifying holdings - multinational firms, large commercial banks and multilateral finance institutions - should be dominant in bearing country-level risk. Two other groups that have particular advantages along one dimension or another are world portfolio investors and local industrialists. Local portfolio investors do not fare so well.

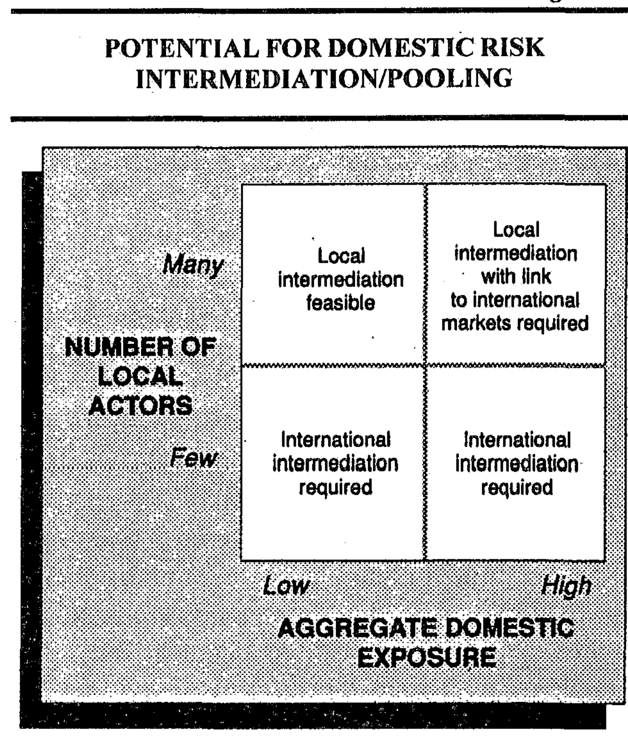
Figure 2 shows the same picture for project-level risks. World portfolio investors stand in the same position as they did with country-level risks. Local industrialists, in contrast, have even more information regarding specific commercial prospects and greater ability to influence commercial outcomes. They also have substantial ability to diversify across commercial risks. International banks typically have less information regarding commercial prospects within less developed countries, and typically less ability to influence commercial outcomes, although, nevertheless, they have a greater ability to diversify these across industries and across countries than they do with country risk. Multinationals come out as being extremely strong in this regard, since they have specific knowledge regarding commercial undertakings, ability to influence commercial outcomes and are still able to diversify commercial risks.

The upshot of this analysis is that there is a mismatch in the ability of various economic agents to take on macro and micro-level risks. Clearly, some form of risk engineering should be welfare enhancing. In an ideal world, those entities best able to assume country risks would do so. There should be a division of labour between the different actors through contracting and financing mechanisms that split the risks along the lines of comparative advantage.

Comparative advantage provides important insights not only into who should bear particular risks, but whether they can be intermediated locally or would require international intermediation. Two factors are critical in determining the ideal locus of risk intermediation. The first is whether the economy as a whole is strongly exposed to the dimension of risk in question. If so, risk pooling to obtain diversification requires intermediation with other countries/agents that do not share this exposure. The second is whether there is a sufficient number of sophisticated autonomous actors in the domestic economy to create a market. If the number is small (fewer than, say, 30 or 40), offshore intermediation will be required for efficiency and transparency, even if in terms of aggregate exposure the risk could be pooled domestically. These two considerations are illustrated in figure 3.

***Figure 3***

**POTENTIAL FOR DOMESTIC RISK INTERMEDIATION/POOLING**




## IV. Mechanisms for risk management

A country with severe aggregate exposures to one or more sources of risk can seek to ameliorate the impact of that risk in several ways. It can shift its structure of production and trade in order to diversify its exposure; through collective action with other countries it can seek to eliminate or at least stabilize the source of risk itself; it can engage in financial transactions to shift some of the risk to which it is exposed to others in the world economy.

These mechanisms are complementary and involve different costs and benefits. Diversification will be desirable as long as it does not require significant sacrifices in terms of comparative advantage or scale economies. Price stabilization efforts will typically require real resources, and most importantly, a degree of collaboration among countries that in general has not been sustainable over time. Financial risks transfers will involve transactions costs and, in most cases, a reduction in the average realization of the performance variable in question over time.

Ideally, a country should pursue each to the point that the degree of risk reduction provided by each mechanism in relation to its resource cost, e.g. the decrease in the average level of exports or increase in the average level of debt service, is equal.

Financial risk management can be undertaken directly through "pure" risk transactions such as futures, swaps or options or it can be bundled together with financing, as in a commodity bond or a floating rate bond with a cap on interest rates. Further, whether bundled or alone, the contract may or may not entitle the risk taker to participate in the control of the operation giving rise to the risks. A futures contract or a commodity bond, for example, would not in general entitle the holder to participate in investment or operating decisions, except in the case of default on the terms of the contract, while a production share or and equity investment combines financing, risk transfer, and management participation. The position of various financial instruments along these three dimensions are identified in table 2.

A fixed or floating rate general obligation debt is, in principle, a pure financing contract, although it does involve general sovereign risk of non-performance. A commodity, interest rate, or foreign exchange rate forward, future, swap or option would be a pure risk contract, conveying no financing. A management contract with incentives tied to performance would be a pure right to participate. An equity investment, of course, involves all three. A production share also involves all three, but it is a more explicit contract than equity and typically limits both the risk exposures and decision rights of the investors relative to equity.

Questions of choice between bundled and unbundled risk transfers are beyond the scope of this report. They depend, among other factors, on the extent to which external parties have skills, technology or networks that are critical to the efficient operation of the investment in question. From a risk-management perspective, it is important to recognize the various mechanisms that shape a country's ultimate risk profile with respect to the various sources of risks inherent in its economy.

Again focusing on oil-producing nations, the fact that Indonesia has financed a large proportion of its oil exploration and developed its reserves through production-sharing arrangements, where the firms exploiting those resources are responsible for the costs of doing so and receive a proportion of the output in return, implies that a large proportion of oil price risk is already shifted from Indonesia to the rest of the world. Countries such as Mexico and Venezuela, in contrast, where the exploration of oil reserves has been exclusively by the State, financed by general obligation money fixed borrowing, all oil price risks are borne locally, and the "income" which the countries receive from these activities is much more volatile than oil prices themselves, since it is a residual after externally determined financing costs are paid. In order to reduce their risk exposure to the level of Indonesia, for example, these countries would have to issue oil-price linked bonds, pre-contract for the sale of oil, or purchase options providing floors on future oil prices.

In general, it will be desirable for countries to engage in bundled as well as unbundled risk transactions, so that they can properly assess the relative cost of transferring risk through both methods and assure themselves of competitive pricing. In those cases where bundling limits the pool of potential investors to a very small number, some degree of unbundling will be required so that there are sufficient contenders to ensure competitive pricing. If contracts involve risks of fulfilment by the State, however, they may be hard

*Table 2*

**MODES OF FINANCIAL RISK MANAGEMENT**

| Instrument | Transfer risk | Provides financing | Includes management services / control |
|---|---|---|---|
| Forward contract | X | | X |
| Futures contract [a] | X | | |
| Option | X | | |
| Commodity bond | X | X | |
| Production share / prefinancing | X | X | X |
| General obligation finance | | X | |
| Project finance | X | X | Limited |
| Management contract | | | X |
| Direct investment | X | X | X |

*a* A futures contract differs from a forward contract in two principal ways. It is traded on an organized exchange and requires regular (typically daily) cash settlements in line with movements in value. A forward contract, in contrast, is a bonding agreement to lock in a price at a future date, As a result of these differences, futures are limited to relatively standard commodities and time frames, but they are much less sensitive to the credit standing of the parties.

to unbundle, unless IFIs step in, a point discussed in Part V below.

## V. National risk-management policy and the role of IFIs

Risk-management policy for a nation involves managing a variety of risk exposures at many different levels. Government plays several roles in addition to being directly responsible for risk management at the central bank, treasury and public enterprise levels. These include oversight, enabling and information provision. The distribution of these four risk-management roles across levels within the national economy is illustrated in table 3, followed by a description of the nature and rationale of each role.

***Oversight/regulation of risk management.*** Oversight or regulation of the risk management of firms and financial institutions involves the creation of incentives and/or imposition of requirements on non-governmental actors to induce them to manage their key risk exposures properly. The justification for such intervention goes beyond a paternalistic interest in the welfare of the parties in question. It is necessary because of two types of "spillovers" of private risks onto the public sphere - the probability that losses resulting from unmanaged exposures will create systemic problems and/or will force the central Government to bail them out.

Regulation is likely to be necessary with large exposures that affect key institutions and/or large numbers of firms or households, especially if they are concentrated in one region. The reason is that pressures for government bail-outs in case of disasters will be irresistible. As a result, private decisions will underrate these risks, and be socially sub-optimal. If large banks perceive that they are "too big to fail," for example, they will gamble with the States' money as major money centre banks and the savings and loan associations did in the United States, costing taxpayers billions of dollars.

The analogy in the case of natural risks would be a prohibition on the building of homes within a flood plain. Here private decisions will be sub-optimal to the extent that homeowners implicitly assume that Government will compensate them for losses in the case of a disaster affecting many homeowners at once.[3] Of course, Government could announce that it would not compensate any "foolish" homeowners, but in the modern welfare State such declarations often lack credibility. Therefore, the Government must regulate to eliminate the distortion created by its own potential for intervention.

Private actors exposed to risks may err either on the side of caution or of daring, from a social perspective. They will err on the side of caution if they take into account volatility that could be diversified at a social level, for example, when there are private risks that do not fully translate into social risks. They will err on the side of daring in those cases where they contribute more to social rather than private risks, either because they trigger systems reaction, for example, failure of banks, or because they assume that society will in some way absorb some losses.

***Market regulation/contractual infrastructure.*** Risk management is a complex process, with new products being introduced continuously as technology advances and as the leading providers of risk management services seek to differentiate themselves from their competitors. As a result, regulators of markets for and providers of risk management transactions, even in the most advanced countries, have a difficult time staying abreast of the practice of leading producers and users of derivative instruments (see, e.g., Group of 30, 1993). Most developing countries cannot and should not expect to keep pace with this full range of developments, especially since in many cases only a handful of local institutions or enterprises will be able to make effective use of them.

A distinction should be drawn between those types of transactions that are likely to involve many local actors, and where it is important to provide broad access, and those where the limited numbers of players, required levels of sophistication, etc., are such that continued reliance on international markets is required. Even where broad local access is called for, the best procedure may involve creation of a clearing house or other mechanisms that ease the access of local actors to existing international markets rather than seeking to create local markets to take their place. Where local markets are feasible, a full regulatory context will, of course, be required. In order to reduce its costs, though, and make sure of its international compatibility, it should draw substantially on models developed elsewhere.

For those risk transfers that will be intermediated offshore, the underlying basic contracts must be recognized in local commercial codes, perhaps by interposing a clearing intermediary with the necessary legal status. In order to allow innovation on the part of those local actors capable of making use of it, local regulations might provide an option for firms to remain entirely within local standards or to comply fully with reporting rules of the United States, United Kingdom, or some other advanced country whose legal framework is closest to that of the country in question.

Markets for risk reduce the divergence between public and private perspectives where private actors face risks that could be diversified at a broader level, since they allow overly exposed actors to shift risks to others, at prices that should reflect the overall incidence of these risks.

Where private actors lack market access because they lack creditworthiness, or because their creditworthiness is reduced by an overlay of country risk (which has the same effect), developing countries will need to take steps to reduce costs to local actors of accessing international markets. The most desirable situation, of course, is one with full access at the country level and a complete internal market with credit information such as that provided by Dun and Bradstreet, stiff contract enforcement, etc. For those countries unable to reach this level, Governments might sponsor clearing-houses that bridge the domestic institutional/contractual structure and international markets. Such a clearing house would require cash settlements with domestic firms, and could by-pass exchange

*Table 3*

**ROLE OF CENTRAL GOVERNMENTS[a] IN OVERALL NATIONAL RISK MANAGEMENT**

| Risk management role / level | Direct responsibility | Oversight regulation | Markets / infrastructure | Information |
|---|---|---|---|---|
| Budget / revenues, mandated expenditures | X | | | X |
| Official international settlements | X | | | X |
| Total international settlements | | X | | X |
| Assets / liabilities of key banks | | X | X | X |
| Operating cash flows / liabilities of major enterprises | | X | X | X |
| Earnings of key sectors, e.g. farmers, miners | | | X | X |
| Asset value of pension funds | | X | X | X |
| Income, wealth of firms, individuals in general | | | X | X |

*a* Central Government in this case refers to the treasury or to some designated overall risk-management unit that may include representatives of the central bank and key state-owned enterprises as well.

controls and other hindrances to cross-border contracting.

While risk management is a critical need and responsibility for developing country Governments, it is also an area where many of them will require IFI assistance. This assistance includes information regarding sources of risk, exposures to these sources of risk, risk-management techniques, and regulatory/institutional developments; technical assistance and training; and, in some cases, intermediation of risk-shifting financial transactions.

***Information.*** IFIs can and should play a major role in increasing risk awareness on the part of developing countries and helping them keep pace with rapid changes in the risk environment, in risk-management techniques, and in regulatory procedures surrounding this dynamic area of finance. A simple step for increasing risk awareness would be for statistical publications to show not only levels of key variables, but also their volatilities, and to place greater emphasis on predictions regarding volatility as well as direction. A few recent World Bank documents have included such information. Studies of particular sectors or countries could also include, where possible, estimates of the sensitivity of key performance measures to particular sources of risk.

***Technical assistance.*** Developing countries are likely to require technical assistance in order to learn to employ risk-management techniques effectively, and especially to create and maintain the regulatory environment required to monitor the risk-management activities of local financial intermediaries and other key autonomous players. Of the two, the regulatory aspects are probably the more difficult.

IFIs might provide computer-based "templates" or models of scenarios of interest rates, exchange rates, commodity prices, etc., that countries might use to test their direct risk-management strategies as well as the risk positions of local intermediaries or firms which they monitor. They also might

institute a common reporting system for the risk-shifting nature of countries' external obligations as well as the "off balance" sheet positions of Governments and key national entities.

If, as suggested earlier, developing countries are to rely largely on advanced countries for regulatory developments, they can reasonably be expected to want some voice in the formulation of these regulations. IFIs here might serve as an intermediary forum, representing needs and interests of those countries whose size or level of financial development does not allow them to operate directly in this arena.

***Intermediation.*** Those developing countries that have access to private world capital markets undoubtedly find themselves facing an ample array of competitive providers of risk-shifting transactions, in which case there is no special intermediation role for IFIs. For those countries that do not have such access, however, risk-shifting transactions that imply future credit exposures such as forwards and long-term swaps are also out of reach. Although these countries would still have access to organized futures markets, the benefits tend to be relatively short term.[4] They also can employ purchased options, the typically large up-front premiums that will have to be financed.

What a commodity-producing country would want to do, in general, would be to transfer revenues from future circumstances when commodity prices are above average to periods when they are very low. If they promise to pay out very large amounts in the case of price windfalls, however, they would probably not be believed, since the temptation to default in such circumstances would be too great (Kletzer et al., 1990).

The World Bank and other IFIs could provide such contracts on a transparent basis, without violating their one-price policy, by adding to the normal loan rate the cost they would incur in the market for selling a put and a capped call on the commodity in order to match the contract it wrote with the developing country. The benefit of "bundling" would be that the World Bank would finance the premium, but would not itself be worse off because it would hold an equally good or better claim against the country.

Even highly creditworthy countries might require IFI intermediation in order to obtain commodity-price-linked project financing, that is financing for a project without any recourse to the State for repayment in case the future cash flows generated by the project were insufficient to meet the obligation. In those cases where the cash flows depend on government actions, e.g. imposing world prices on energy sold in local markets, the country probably would not be able to obtain project financing because of the combination of general country risk and compliance risks associated with the specific arrangement. The World Bank, through its expanded co-financing programmes, is in a very strong position to take and mitigate such compliance risks, and therefore can be a very useful participant. World Bank intermediation could deal with a series of completion and contracting risks and allow a country to lay off underlying price risk without unconditionally guaranteeing repayment. Thus, by accepting and passing on a conditional state guarantee, IFIs would actually be reducing the State's credit exposure.

## *Notes*

1 See Blitzer, Lessard and Paddock (1984) for a discussion along these lines of alternative oil contracting arrangements.

2 Country funds are an exception which will be taken up again below.

3 In contrast, there would be little pressure for Governments to compensate an individual homeowner should the house burn down in an isolated occurence.

4 Short-term transactions, however, can in many circumstances provide effective hedges against longer-term positions if the amounts covered adequately reflect the time period to be covered. For example, in order to cover a three-year exposure, say of commodity revenues, with three-month forwards, an amount equal to three years of sales would have to be rolled forward every three months.

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