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AVRAMOVIC

Paper presented by Mr. Avramovic at the 2nd Annual Meeting of the National Association of Business Economists in New York City on Oct. 19-20, 1960

The Work of International Agencies on International Statistics and Economic Analyses

The scope and amount of statistical reporting and economic analytical work done by international agencies have increased at a rapid pace during the last ten years. There is now a continuous and voluminous stream of material on a very wide range of subjects. This makes it impossible to present an exhaustive survey of all the activities performed by all the agencies. The purpose of this note is much more limited: it sets out the main lines of statistical inquiry and applied research that are being undertaken by the most important of the international organizations.

Organizations

Most of the statistical and research work is done by the United Nations, their regional Economic Commissions1/ and the specialized agencies, viz. the Food and Agriculture Organization, International Bank for Reconstruction and Development (World Bank), International Labor Organization and International Monetary Fund. In addition, there are three more international bodies whose research activities occupy a prominent place in the current literature in international economics: the Secretariat of the General Agreement on Tariffs and Trade (GATT), the Bank for International Settlement (BIS), and the Organization for European Economic Cooperation (OEEC).

Statistical Reporting

Three monthly publications contain most of the current flow of economic information on developments in the world economy: the U.N. Monthly Bulletin of Statistics, the FAO Monthly Bulletin of Agricultural Economics and Statistics, and the IMF International Financial Statistics. While these publications in part cover the same area (e.g. both UN Monthly Bulletin and IMF International Financial Statistics contain data on international trade, gold and foreign exchange holdings, wage and price indices), there is still a distinct difference among the three. The emphasis in the UN Bulletin is on population and industrial production statistics, both for the world as a whole and for individual countries; and the production part is particularly detailed, covering not only economic aggregates - national accounts, industrial indices and their meaningful subdivisions - but also physical quantities of the most important industrial commodities in the producing countries. The FAO bulletin follows agricultural production, trade in agricultural products, and agricultural prices, both domestic in the producing countries and international on the world markets. In contrast with these two "production" publications, the International Financial Statistics concentrates on monetary, financial and balance of payments developments. Detailed data are provided on all major variables, and an attempt is also made to consolidate, for each individual country, the important financial flows into larger analytically significant

1/ For Europe, Asia and the Far East, Latin America, and Africa. The Commission for Africa, which was established only recently, has not yet started its publications; this is expected shortly.

aggregates. Information by country is also given on interest rates for major classes of paper, share prices and the key items of commercial bank's balance sheets (consolidated).

While these three publications are the "bread and butter" of international statistics, there are also others, regional in scope and appearing at regular bi-monthly or quarterly intervals, which contain additional series frequently designed to serve particular analytical purposes. The OEEC puts out two statistical bulletins, one on general statistics (Part I, monthly and Part II, bi-monthly) and the other on foreign trade statistics (Parts A and B, bi-monthly and Part C, quarterly), covering the OEEC countries, the United States, Canada, and Yugoslavia. These series are very comprehensive and lend themselves easily to comparative study of economic growth and of the current state of economic conditions. The UN regional Economic Commissions for Latin America and Asia, in their economic bulletins published semi-annually and tri-annually respectively, produce regular statistical series covering, in particular, national accounts and major production and foreign trade data by region and by country.

Finally, several of the international agencies publish annually statistical reports which contain both current data and long-run series. The United Nations publish each year the Statistical Yearbook, the Demographic Yearbook, the Yearbook of National Accounts Statistics, and the Yearbook of International Trade Statistics. The Food and Agriculture Organization puts out the Production and Trade Yearbooks, which cover agricultural commodities only. The International Labor Office publishes the Yearbook of Labor Statistics. The International Monetary Fund issues its Balance of Payments Yearbook. The International Bank, the International Monetary Fund and the United Nations jointly prepare the statistical series "Direction of International Trade", which contains detailed data on origin and destination of trade for each country.

World, Regional and Country Analyses

The analytical endeavors of international agencies are as multifarious as their statistical undertakings. The postwar work had its predecessor in the brilliant pioneering efforts of the Secretariat of the former League of Nations. In addition to their famous annual reviews (their current work on the course and phases of the Great Depression still remains, after thirty years, the must for a research into the international aspects of the depression), they have produced such classics as "Industrialization and Foreign Trade", written mostly by Folke Hilgerdt, and "International Currency Experience", authored primarily by Ragnar Nurkse. These works are outstanding examples of successful integretion of theoretical analysis and quantitative findings; and, in my view, they have set a very high scholarly standard not only for international agencies but also for national institutes of economic research.

The analytical work at present is much more dispersed geographically, it is issued more frequently and is far more numerous than in the inter-war period. The United Nations Headquarters publish annually their World Economic Survey; each of the UN regional commissions issues annually their regional economic reviews, which also contain many country analyses; the World Bank makes available its annual report which reviews Bank activities and frequently summarizes some of

the major developments bearing on Bank operations; the International Monetary Fund publishes each year its review of trade and monetary developments in the world as a whole and in particular countries, as well as a report on foreign exchange restrictions in each of its member countries; the GATT puts out its annual analyses of international trade movements; the FAO publishes each year the State of Food and Agriculture, which reviews world production, consumption, trade and price movements of agricultural products; the BIS issues each June its review of the world economic developments, with special emphasis on the behavior of capital and money markets and national monetary and financial policies; the OEEC publishes yearly analyses of economic growth in Western Europe, its cyclical movements and its trade and balance of payments developments.

This impressive list of annual publications does not exhaust all the work that is being done in the field of regional and country research. The UN regional commissions' bulletins contain analyses of special topics bearing either on a particular region, a particular industry or a particular country. In addition, the Commission for Latin America has published several special country studies with an exhaustive appraisal of their economic growth in the past and prospects for the future (e.g. on Brazil, Colombia, Mexico). The ILO monthly International Labor Review, contains country studies on labor conditions, wage levels, labor legislation, etc. The International Bank has published during the last three years two books on international capital flows, international indebtedness and debt servicing capacity of its member countries, with special emphasis on low-income borrowers. These publications cover the periods 1945-1955 (published in 1958) and 1956-1958 (published in 1960), respectively. Also, the International Bank, publishes reports of its country survey missions. Seventeen such reports have been issued so far. Each of these reports analyzes the economic conditions and prospects for future growth, as ascertained by the Bank mission to a particular country. The latest two reports cover Thailand (1959) and Lybia (1960).

Given the number of publications and the range of problems they cover, it is impossible to present in this summary any meaningful appraisal either of the analytical techniques that are applied or of the findings and conclusions that are reached. One point should be stressed, however. Almost any of the annual publications, and each of the special studies, goes far beyond the routine review of short-term developments. As a rule, an attempt is made to appraise these developments in the perspective of long-term trends; and also the experience of other countries is almost invariably invoked. In addition, most of the annual publications usually contain exhaustive analyses of particular subjects which are not only topical but which have also more than a transitory significance. For example, the World Economic Survey 1957 contains an analysis of the causes and consequences of the inflation of the 1950's, the Survey for 1958 gives a review of commodity trade and policies in the postwar period and the Survey for 1959 concentrates on the capital formation trends during the last ten years. Another example is the analysis of the planning and finance of investment in the Soviet Union and Eastern Europe, published in the Economic Survey of Europe in 1955; the same issue contains an appraisal of the investment problems of Western Europe and of the financial obstacles to industrial investment in this area. Further instances are the studies of the UN Commission for Asia and the Far East in their Survey 1957, of the postwar growth and structural change in Japan, the development programming in India and the industrialization in the centrally planned

economy of Mainland China. The GATT Secretariat published in 1958 the now famous study on long-term trends in international trade, which was prepared by a panel of experts consisting of Professors Haberler, Tinbergen, Campos and Meade. The International Bank studies on international capital flows and international indebtedness contain also analyses of postwar growth trends in low-income countries, their capital accumulation and the structure of their balances of payments.

Commodity Studies and Economic Projections

In addition to country analyses, extensive work is done on long-term trends, short-term developments and future prospects of major commodities entering international trade. Considerable use is made in these studies of econometric analytical techniques. Much of the work remains unpublished and serves the internal uses of the agency in which it is done. But current developments in world commodity markets are followed carefully by several agencies and their analyses are published regularly. For instance, the FAO and GATT annual surveys, already mentioned, devote major place to reviews of commodity markets. The UN Headquarters publishes each year its Commodity Survey. In addition, several agencies issue special long-term commodity studies, and there is reason to believe that this line of applied research will expand further. In recent years, FAO has published analyses of past trends and future prospects of several agricultural commodities (e.g. sugar, tea, citrus fruit); the same agency has just published a study on world demand for paper covering the period 1960-1975. The Economic Commission for Europe issued in 1959 a study on long-term trends and problems of the European steel industry. The study covers world developments in production and consumptions of steel since the turn of this century and contains projections of consumption and trade through 1975. The Economic Commission for Latin America published in its bulletin for October 1959, an analysis of prospective production and demand for rolled iron and steel products in the region.

The increasing interest in commodity studies is closely connected with the unfavorable price developments in a number of agricultural products since the mid-1950's. But this interest also reflects the fact that world and regional demand for industrial raw materials and for manufactures, particularly of basic industries, has shown a persistent upward trend throughout the postwar period. This called for systematic analytical work if the future demand was to be appraised with some certainty.

In addition to commodity projections, international agencies are also engaged, to a modest extent so far, in forecasting the major economic variables, e.g. over-all output, investment, trade. The short-term forecasts are usually contained in their annual reports. With respect to medium-term and long-term projections, most international agencies rely on the work done on the national level; and they consolidate country forecasts to arrive at world aggregates which then serve as bases for commodity projections. But there have also been attempts by some of the agencies to construct their independent income growth estimates. In addition to those done by some of the agencies for their internal use, and in addition to World Bank country survey studies and ECLA's work on Latin American countries mentioned earlier, the OEEC has produced several aggregate projections for Western Europe. The

latest one covers the period through 1965 and 1975; it was prepared in conjunction with the estimate of the European energy requirements and their pattern in the future. (The Robinson report, 1960). The GATT secretariat published in its annual report for 1956 an illustrative model of income and import growth of industrialized countries through 1975. Judging by recent developments, it is likely that the medium- and long-term forecasting will occupy in the future an increasing proportion of staff work in international agencies.

In Lieu of Conclusion

A note of warning may well take the place of conclusions of this review. Never in economic history has such a comprehensive stream of economic information on national and international developments been available. And yet, the imperfections of data, particularly when they cover economic aggregates rather than a single product or activity, are still great. This is especially so in those low income countries where more refined statistical work and systematic economic analysis have been started only recently. But in addition to weaknesses of statistical organization and reporting, there are also serious methodological problems in measuring economic change for those countries which move rapidly - and these countries are of most analytical interest. Rapid change from a low initial base implies substantial shifts in the composition of output and in relative prices; and the greater these shifts the more difficult is the problem of weighting in the construction of index numbers and consequently the more indeterminate is the precise magnitude of the change in the national output as a whole.

There is one additional point to be made. With the exception of North America, some countries in Western Europe and Japan, the evaluation of near-term business prospects and cyclical developments still has to be based on very few indicators of general nature. Such information as capital expenditure programs, consumer purchase plans, volume of orders data, up-to-date reports on stocks and on sales - are simply non-existent in the overwhelming majority of countries. Much time will be needed before this kind of business information becomes available.

But these lacunae should not obscure the fact that an impressive progress has been made during the last ten years. The flow of statistical data and analytical writings regularly issued by international agencies have grown without interruption and there are no signs that this process will stop. What is perhaps mostly needed at the present juncture is an improvement in the quality of existing information; and judging by past performance, there are grounds to believe that this will progressively occur.

Dragoslav Avramovic
Economic Staff
October 18, 1960.

ECONOMIC DEVELOPMENT INSTITUTE

1963-64

9th General Course

3/1

Seminar 3: Historical Aspects of Development

Session 1: Tuesday, October 22

Topic: Recent World Economic Growth

Reading: "Postwar Economic Growth of Low Income Countries" (attached)

Speaker: Mr. Dragoslav Avramovic (IBRD)

Outline: None

Additional Reading:

United Nations, World Economic Survey, 1960, chapter 2, pp. 57-87

POSTWAR ECONOMIC GROWTH OF LOW INCOME COUNTRIES

I. SCOPE OF ANALYSIS

1. This paper reviews major economic developments in the low-income countries since the Second World War. The emphasis is on establishing the facts, i.e. on the quantitative magnitudes of economic growth and on the inter-country and inter-regional differences in over-all economic performance. But an attempt is also made to appraise the main factors that have determined the rate and the pattern of change. The major economic variables and their inter-relationships are identified and their impact on aggregate economic movements assessed. As far as is necessary, the analysis is carried out against the background of economic trends in the industrialized countries. Thus, while the paper is focussed on the underdeveloped areas, it also touches, in broad outline, on the major changes which have taken place in the world economy as a whole during the last ten to fifteen years.

2. Two qualifications should be set forth at the beginning. First, the statistical bases of the findings contained in the paper are occasionally very weak. Never in economic history has such a comprehensive stream of economic information been available. And yet, the imperfections of data, particularly when they cover aggregates of commodities or economic activities rather than a single commodity, are still great. This is particularly so in those low-income countries where systematic economic analysis has been started only recently in conjunction with these countries' development programming. But in addition to weaknesses of statistical organization and reporting, there are also serious methodological problems in measuring economic change. Rapid change implies substantial shifts in the composition of output and in relative prices; and the greater these shifts the more difficult is the problem of weighting in the construction of index numbers and consequently the more indeterminate is the precise magnitude of the change in national output as a whole.1/

3. Second, any analysis of changes in economic variables over time poses some major problems of interpretation. Is the period under review long enough to warrant any attempt at generalization regarding the rate of change? To what extent is this rate unduly influenced by abnormalities prevailing in terminal years? These questions are particularly relevant in the context of this paper. The postwar period is long enough to permit meaningful analyses both of the facts and of the economic, social and political forces that have determined these facts; but it is not long enough to enable us to treat the economic changes that have taken place as necessarily reflecting long-run trends. Much of what has happened since the war has been of a temporary and cyclical nature; and more time has to elapse before we can assess with certainty the causes and consequences of economic developments we have been able to observe. This uncertainty about the relationship of structural and cyclical factors presents the major pitfall which any analysis of the postwar period has to face.

1/ Simon Kuznets and Alexander Gerschenkron have discussed this problem at length in their writings.

II. DIMENSIONS OF POSTWAR GROWTH

4. Even when all due weight is given to the qualifications mentioned above, there is still little doubt that the postwar period was one of the more prosperous in recent economic history. In this period, but particularly during the decade 1946-1955, the high-income industrialized countries experienced a sustained level of full resource utilization, which resulted in considerable rise in real income. The U.S.S.R., the main industrialized country in the group of centrally-planned economies, showed a very high rate of output growth. At the same time, several mid-income semi-industrialized countries proceeded with a rapid economic advance. Finally, low-income primary producing regions, benefiting from fairly good demand conditions for their export products during a large part of the postwar period and enjoying considerable capital inflow throughout this period, succeeded in expanding their output at rates which were probably higher than those they had experienced in the more distant past. A slowing down in the rate of income growth of some mid- and low-income countries, primarily in Latin America, became apparent after 1955 as the terms of trade of primary products deteriorated under the combined impact of cyclical recession in the major industrialized countries during 1957-1958, and excessive supply of several primary products which still persists. But the latter part of the 1950's also witnessed an acceleration of capital accumulation in several major low-income economies, particularly in Asia, as their investment targets were raised and their capital inflow or domestic savings substantially expanded.

5. The strength of the expansive forces operating in the period since the Second World War can be appraised by comparing postwar rates of economic growth with those that prevailed over the long-run as well as with rates recorded in the boom era following the First World War. While all comparisons which extend over long periods are statistically suspect, it is fairly certain that growth since the last war was faster than in earlier periods. Table I shows that, during 1948-1955, world industrial output expanded at 6.5% per year, compared with less than 4% in 1870-1913 and 5.2% in 1920-1929.1/ World agricultural output rose 3% per annum in the decade 1946-1955, compared to an estimated 1-2% in the preceding several decades.2/ The developments since 1955 have been somewhat less favorable. The rate of output expansion in the world as a whole was below that of the first postwar decade. However, it was still above the long-run rate.

6. It is not possible on the basis of the available evidence to state with certainty whether the postwar rate of expansion in commodity output in the low- and mid-income countries has lagged behind that in the industrialized areas. According to one computation (Table II), total commodity output in the industrialized countries rose at 4.8% annually in 1948-1955/57, while the yearly rate of expansion in the non-industrialized areas was estimated at 4.1%. 2/

1/ All tables are given in the Statistical Appendix.

2/ These computations exclude output changes in Eastern Europe, U.S.S.R., and Mainland China.

Production of primary products rose faster in less developed countries, but their rate of expansion in manufacturing, according to this computation, appears to have been somewhat slower than the corresponding rate in industrialized countries. This latter finding is in some contradiction with the evidence derived from the regional indices of manufacturing output (Table III). According to these indices, manufacturing output of North America and Western Europe combined rose at an annual rate of 6% in 1948-1955/57; and if the period of observation is extended through 1959 (thus including the recent recession) the rate of increase becomes 5.2% (1948-1959). In contrast, the rate of growth in manufacturing output in Latin America and Asia combined (excluding Japan and Mainland China), amounted to 6.4% during the eight years 1948-1955/57 and 6.2% during the eleven years 1948-1959, i.e. it was above the rate recorded in the high-income industrialized areas for both periods. However, it is quite possible, for reasons mentioned in the first section, that manufacturing indices in the non-industrialized countries contain an upward statistical bias compared to the indices of the industrialized areas.

7. On balance, it would seem that aggregate commodity output in the low-income countries increased either at the same or slightly above the rate of expansion in the high-income industrialized areas. The comparison is less favorable if per capita growth rates are reviewed (see Tables IV and V which give aggregate and per capita output growth rates by countries)1/. The growth of population has accelerated substantially in the recent past; and while this acceleration has taken place in both the developed and in the underdeveloped areas, the present rates of population growth in the latter are, on the average, appreciably above those in the developed countries. As a result, the percentage advance in per capita real output was considerably more rapid in Europe and, on average, probably equal or slightly faster in North America than in the majority of low-income countries. Finally, in absolute terms (as distinct from relative rates of change), the difference in the increment to income, either aggregate or per capita, between industrialized and non-industrialized countries was necessarily very large, given the differences in the initial absolute levels of income per head.2/

8. There are two other yardsticks which can be used for appraising the magnitude of the recent economic growth of the low-income countries. First, this growth can be compared with that of the presently developed areas in earlier periods of their economic history. Table VI presents the rates of increase in aggregate and per capita income, for various periods, in a dozen advanced countries since about 1860. If this evidence is related to the data contained in Table IV, it appears that in a large number of the less developed countries output has grown since World War II at annual rates which compare favorably with the experience of the developed countries in the past. In a number of

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1/ Output is defined here to include both commodity production and output of services.

2/ An addition of 10% in per capita income is equivalent to $10 in a country where the initial level of income amounts to $100; the same percentage addition represents an absolute increase of $100 in a country at an initial per capita income of $1,000. On the other hand, it may be argued that the "marginal utility" of an absolute addition to income is much greater at a low level of income and that the "utility" decreases as income level rises.

countries in Southern Europe, Latin America and in some countries in Asia, rates of growth in both aggregate and per capita output have been even higher. But the reader must be warned again that computations covering such different periods of time suffer from serious statistical limitations.

9. Second, probably the most relevant from the analytical point of view would be a comparison of the recent rates of output growth in low-income countries with the rates recorded in the past in these same countries. Such a comparison would show whether the expansive forces now operating in the underdeveloped world are substantially stronger than in the past. Unfortunately, the available statistical evidence is quite inadequate for this purpose. In a few cases for which long-run growth series have been computed, the past growth rates appear, on the average, below those of the last ten to fifteen years. There is one exception - Argentina, but this country could hardly be considered a low-income country; also, there have been special factors at work, which have been responsible for the sluggishness of the Argentine postwar growth. For low-income countries for which no comprehensive evidence on the past performance is available, there are general reasons to believe that recent growth must have been substantially above that in the more distant past. The underdeveloped countries would have been much more advanced if their economies had been growing at anything similar to the postwar rates.

III. CHIEF EXPANSIVE FORCES IN LOW-INCOME COUNTRIES

10. It has become almost a platitude to say that dynamic factors underlying postwar growth have differed from country to country, depending on circumstances in each particular case. Nevertheless, this should be repeated in order to place into proper perspective the generalizations which are the concern of this section. There have been certain common forces which have been operating in large groups of countries, and these forces are identified and briefly discussed below. But in many cases there have been many other factors at work as well, superimposed upon each other. While generalizations are useful and indeed indispensable, they are also simplifications and therefore in a certain sense distortions of a more complicated reality.

Drive for Development

11. Probably the most important distinguishing feature of the postwar period has been a strong and rising developmental drive in almost all underdeveloped countries. Increases in output and investment and improvements in the standard of living have become the essence of political programs in these countries; and goals of economic growth have permeated the whole social and political structure. National authorities, in many areas only recently born as a result of political independence, have become the main vehicles for economic growth and social change. Government has undertaken the role of stimulator and coordinator of investment; absence of governmental development and investment programming has become very rare. In many areas, government itself has been a major investor. Thus, the share of public investment in total investment in the countries of South East Asia has been estimated at about 35-40% in the mid-1950's. In Latin America, the proportion averaged about 30% in the postwar period. Most of this investment has been in the field of overhead capital (e.g. transportation, power). In the centrally-planned economies, almost all non-agricultural investment has been public.

12. Acceptance of economic growth as the chief goal of economic and political policies has led to an expansion of over-all demand in the domestic sector of the less developed countries. This has often meant an excess of demand. Where high public investment was accompanied by low fiscal effort or by lax fiscal and monetary policies, persistent inflationary pressures developed sometimes resulting in a diversion of resources from development to consumption and thus hampering the fulfillment of the original investment and development targets. But, in general, the developmental drive which has embraced the underdeveloped world since the end of the war, has provided the continuing impetus for growth and for rising demand in the domestic market. As a rule, and unless circumscribed by legislative limitations, this impetus has led to a simultaneous growth of private investment in the less developed countries, which has in turn, also stimulated demand. The chief bottlenecks to growth have been the scarcity of investible resources and the absence of good planning, good management and good fiscal policies rather than the lack of effective domestic demand for final goods. Of course, there have been cases in which the sluggishness of the domestic market has been the chief obstacle to economic growth; but it seems safe to say that these cases have been exceptions rather than the rule.

13. Public savings (i.e. surplus of government revenue including profits of publicly owned enterprises, over government current expenditure) has been the most important single source of finance for public investment in the majority of countries for which data are available. Public savings has covered in some cases the entire cost of public investment; at the other end of the range have been countries where public savings has financed only one-fifth of investment in the public sector.1/ Other sources of finance have been government borrowing on the domestic capital market, capital inflow from abroad and money creation (i.e. financing through bank credit). Government borrowing on the home capital market has not been of major significance for a number of reasons, the relative lack of transferable savings, absence of financial institutions and persistent inflationary pressures being the most prominent. Of far greater importance as a source of finance has been governmental borrowing abroad, i.e. foreign capital inflow on public account. This has played a very significant role not only as a supplement to domestic public savings, but has served at the same time as an additional source of foreign exchange to cover the heavy external cost of imported equipment for public overhead investment.

14. An important part of the developmental drive in low income countries has been the emphasis placed on industrialization. In almost any low-income country development programming has included provisions aiming at accelerating, through tax facilities, other subsidies, protection, etc., the establishment of new industries and growth of existing industries. To be sure, in cases where this emphasis has been excessive, i.e. at the expense of the adequate growth of other sectors, the industrialization policy could not be sustained and the result was sectoral disproportions and sluggish over-all growth, at least for a time. 2/

1/ For details on the sources of finance for public investment see the Economic Staff study "Financing of Public Investment in Underdeveloped Countries", October 1960.

2/ For further analysis see Sections IV and V.

Barring such extreme cases, however, industrialization had expansive effects. Industrial growth was facilitated by the enlargement of the home market for manufactures, due to over-all income expansion induced by export growth and by rising government development expenditure; but at the same time, the industrial investment itself, by raising effective demand, served to expand the absorptive capacity of the home market.

15. A particular feature of the postwar industrial growth has been a much faster expansion of capital goods, other durables and chemicals (heavy industry) than of consumer manufactures (light industry, i.e. textiles, leather, food processing, etc.). This discrepancy was carried to an extreme in several centrally planned economies, resulting for a time in an absolute fall of per capita personal consumption. To a lesser, but still substantial, extent, the divergence of the rates of expansion within the industrial sector has also taken place in Latin America and in Asia,1/ as indicated in Charts I and II.2/ Such a pattern of industrial growth, by itself an indication of a growing economy, implied, on the average, proportionately heavier investment per unit of output and, again on the average, larger masses of real capital for any single investment project. Both these phenomena tended to raise the effective demand in the economy. The financing of private industrial investment appears to have been assured, in largest part, through ploughing back of profits or borrowing abroad;3/ but it also involved frequent resort to the credit system. As in the case of government overhead investment, if the financing of private industrial investment took the form of excessive money creation, it was accompanied by inflationary pressures of varying severity. These pressures were intensified if the sale of commodities produced by the new industries also required extension of credit by banks; and this probably happened fairly frequently, since output expansion was particularly fast in durable goods, i.e. commodities whose purchase required large money outlays.

Expansion of World Market

16. The second major expansive force which played a far-reaching role in a part of the postwar period was the growth of world demand for primary products. This expansion came after twenty years of stagnation in the volume of primary products trade, with its negative impact on the growth process of producing countries. The postwar expansion in the exports of primary products was determined by the sustained level of economic activity in the industrialized countries; this was accompanied by a continuous rise in their demand for imported goods and services. Since the Second World War, the volume of world trade (including both manufactures and primary products) has been expanding at an average annual rate of 7%. This was twice as fast as the growth which occurred in the four decades preceding the First World War, and it contrasts sharply with the extremely sluggish development of world trade during the inter-war period (see Table VII).

1/ Asia is defined here to exclude Japan and Mainland China.

2/ All charts are shown at the end of the Statistical Appendix.

3/ In the case of government-owned enterprises, an additional source of finance was government budget.

17. Given the dependence of many less developed countries on the production and export of primary products, demand conditions in the external market were of paramount importance for the economic development of these countries. External demand conditions were not uniformly favorable. The demand for several primary commodities expanded very little or not at all: jute and jute products provide striking instances of a stagnating trend in world demand until recently, Pakistan and India being the countries most affected. The volume of world trade in cereals, some oils and fats and most textile fibers also developed sluggishly, reflecting partly low income elasticity of demand in the developed countries, development of home output of competing products in the importing regions, and the growing substitution of synthetics. In contrast, the volume of world trade in fuels, metals and rubber expanded very rapidly under the impact of investment expenditures in industry and transportation and rising consumption of durable goods. A substantial increase also took place in the volume of world trade in lumber and timber products. In the case of beverages (coffee, cocoa), the volume of trade rose moderately, but this was due to scarcity of supplies rather than to lack of demand. World market demand was also very strong for citrus fruits, a high quality food.

18. The volume of world trade in primary products as a whole rose considerably less than the volume of trade in manufactures: between 1948 and 1955-57, the volume of world trade in manufactures was rising at almost 9% per year, while the annual rate of increase of trade in primary products was 4.7% (3.3% excluding petroleum). Compared to the immediate prewar period, the trade in manufactures approximately doubled by the mid-1950's; the trade in primary products rose by 25-30%. At the same time, however, the relative prices of these two commodity groups in the decade 1946-1955 were more favorable for primary products than in earlier periods. The over-all price level of primary products in the postwar decade was about 180% higher than in the late 1930's, while prices of manufactures approximately doubled. As a result, the terms of trade of primary producers improved by 40-50%. It should be mentioned, however, that this substantial improvement occurred in relation to a period when prices of primary products were abnormally low. The extent of the improvement appears smaller when compared with earlier periods, but it was still significant. Available estimates suggest that the improvement was about 20-30% compared to the late 1920's and 5% compared to the level in 1913. (See Chart IV).

19. The impact of the improvement in the terms of trade has been manifold. While the terms of trade of a country are improving, its real income rises faster than its output, since a unit of exports buys an increased volume of imports; and, the larger the export sector in total product, the greater the windfall addition to real income. The attached Table VIII shows the extent of this windfall gain for the Latin American countries, where it was of most importance, as well as for several other countries. Aggregate output in Latin America in 1945-1955 rose 4.9% annually, while real income, which also includes the effects of changes in the terms of trade, increased on average at more than 6% per year. Conversely, in Pakistan, where the terms of trade deteriorated, real income rose more slowly than output. For a decline in export prices relative to the unit price of imports reduced the purchasing power of exports. This was a general phenomenon in the recession 1957-1958, when the terms of trade of primary producers deteriorated and when their real income rose less than their real output (see Table IX).

20. Improvement in the terms of trade, where it occurred and as long as it lasted, not only implied a rate of increase in income faster than in output but also served to alleviate foreign exchange bottlenecks which might otherwise have impeded progress. A rise in export prices meant that the capacity to import increased faster than the volume of exports, and this released resources which were used in industries catering to the domestic market. Also, an improvement in the terms of trade tended to raise rates of savings. The rise in export prices frequently meant an increase in public revenue through export taxes, income taxes and marketing board profits. As it increased the margin of selling prices above costs, a rise in private profits also occurred. On the whole and up to mid-1950's, the level of export prices for the majority of primary products was such as to exercise a favorable impact on the capacity of primary producers to import and save.

21. Towards the end of the postwar decade the terms of trade of primary products deteriorated compared to the postwar average. Their prices were falling from 1954 through mid-1959, while prices of manufactures were rising through mid-1958. The decline of prices of primary products resulted partly from slackening world demand and partly from output expansion of primary products which reflected substantial investment undertaken in earlier years. The deterioration in the terms of trade had a negative impact on the availability of resources to the primary producing regions. Output estimates for the years 1957-1958 show a certain deceleration in growth in both the developed and some of the less developed countries, although the majority of the latter showed a continued expansion. In the developed countries, the deceleration was primarily the result of the cyclical downturn following the boom 1950-1955. In the less developed countries, the slowing-down, where it occurred, reflected partly temporary factors in some cases (e.g. poor crops), partly the deterioration in the external financial position and partly the sluggish external demand.1/ While the cyclical upturn in 1959-1960 has led to an improvement in prices of cyclically sensitive commodities, it must be borne in mind that excessive supplies of some primary products combined with low price elasticity of demand have acted and may continue to act as a deterent to an appreciable increase in foreign exchange earnings of low-income countries in the near future. What would be the impact of such a development on income growth depends on a series of factors, one of which is discussed below.

The Role of Capital Inflow

22. The third factor which has greatly influenced postwar growth, particularly in the second half of the postwar decade and in the last few years, has been the inflow of foreign capital, which has supplemented the domestically generated resources available for investment. The chief source of capital has been the United States; but a number of European countries (France, United Kingdom, Switzerland, Belgium, and more recently, Western Germany and the Netherlands) have also been capital exporters. Since 1955, the U.S.S.R. has become a significant capital exporting country to less developed areas, particularly in Asia and the Middle East. Aggregate capital outflow on both public and private

1/ See Chart III which shows the index of mining output in Latin America and Asia (excluding Japan and Mainland China) in the postwar period. The rapid growth in Latin American mining was interrupted in 1957 and 1958, mainly under the impact of the recession; expansion was resumed in 1959 and 1960.

account in the decade 1946-1955 was substantially above that recorded in the decade 1920-1929 (after adjustment for changes in the value of money). A substantial part of these capital flows occurred among the developed countries themselves (United States to Western Europe and to Canada, Australia and South Africa; Europe to United States and to Canada, Australia and South Africa); but the flow to the less developed regions was also of great significance and showed a rising tendency in the last several years.

23. An array of official agencies has channeled public capital transfers to the less developed countries. The principal agencies have been the International Bank, International Monetary Fund, U.S. Government agencies, including the Export-Import Bank and the Development Loan Fund, and the Commonwealth Development Corporation. In the European countries, the primary role has been played by government departments guaranteeing medium-term export credits; but, in a number of cases, notably France, the United Kingdom, and Belgium, governments have directly transferred resources to their dependent territories. Public capital transfers were used to finance social overhead capital, electrification and transportation, and also to finance investment in manufacturing. The Asian countries have most recently been the largest recipients of public capital flows. Of most significance has been the fact that public capital flows have accelerated in all directions in the last few years at the same time as the terms of trade of primary producing countries were deteriorating (Latin America) and as investment targets were substantially raised (Asia). Capital flows, which have traditionally been most sensitive to cyclical disturbances, have thus shown a great stabilizing influence, rising rather than declining in times of difficulty and need.

24. Most private foreign investment in the less developed countries since the war has been direct investment (i.e. having the controlling rather than the loan interest). The area distribution of private capital flows was essentially determined by the increase in world demand for fuels and other primary products, particularly minerals, during the first postwar decade. Large-scale development of petroleum resources in the Middle East and Venezuela and the expansion of mineral output in Africa and Latin America were largely financed by foreign direct investment. In addition, manufacturing industry catering to the rapidly growing domestic market attracted foreign private capital in Western Europe, Australia and Canada, and also in several Latin American republics, particularly Brazil and Mexico. In contrast, the less developed countries in Asia, with the exception of the Philippines and Malaya, remained outside the network of private capital exports in the first postwar decade. There has been an increase of private capital inflow into this area in recent years.

25. The statistical material is not yet sufficiently refined to permit a reliable estimate of the relative role of foreign capital in financing economic development in the less developed countries. This role has varied greatly from case to case and from one period to another. Any attempt at quantitative measurement of the contribution of foreign capital faces formidable conceptual and statistical problems. Before these problems are tackled, it is useless to put forward any figures, even as a guess. The only statement which can be ventured at the present time - too general to mean much - is that an absence of capital inflow of the postwar magnitude would have involved either a substantial curtailment of capital formation or a cut in personal consumption for a time or, most likely, both, but in different proportions in different countries.

26. The strength of the three forces analyzed above - expansion of the domestic market under the impact of the developmental drive and industrialization, expansion in world trade and relatively high prices for primary products until 1955, and foreign capital inflow - differed greatly as between particular countries. The results, expressed in the rates of income growth and in the behavior of other crucial variables - rates of savings and investment, pattern of output, rates of export and import growth, yield of capital in terms of income - have accordingly varied from country to country. These are the concern of the next two sections.

IV REGIONAL CHARACTERISTICS OF GROWTH

Developments in the Industrialized Areas and Their Impact on Low Income Countries

27. The industrialized areas provide the overwhelming proportion of the total market for export products of low income countries. Consequently, the postwar behavior of this market was primarily determined by the import propensity of the industrialized regions; and this propensity in turn was a function of their rate of growth in aggregate demand and of the change in their pattern output. Since the industrialized countries are also the only source of international capital funds, the trends in these countries' capital accumulation - supply and demand for savings - have been the major factor determining the aggregate amount of international transfers of capital. These two flows - commodity trade and international capital movements - will continue to provide the economic link between the industrialized regions and the low-income countries.

(a) The United States

28. The postwar developments in the U.S. economy have not yet been satisfactorily explained. The increase in output, spectacular during the war, continued during the following period without major interruption. Contrary to widespread expectations, the United States did not experience a protracted cyclical decline, although it underwent three recessions (1948-49, 1953-54, and 1957-58). These proved short-lived and their international consequences, with an exception for the last one, were limited. Of most importance for the outside world was the fact that United States imports showed a sustained growth throughout the postwar period. Their value, partly under the impact of rising import prices, increased at a faster rate than total income. As a result, the proportion of income spent on imports tended to rise in the postwar years - a medium-term development in striking contrast to the secular relationship of the two variables in the last half century or more. This was the major factor in eliminating the dollar problem, which was considered almost intractable in the early postwar years.

29. The U.S. total income rose at a rate surpassing 4% p.a., in the period 1948-1955. Productivity per manhour rose faster than over the long-run. The gains were particularly striking in agriculture; its rate of productivity growth was twice that in manufacturing. Both the agricultural and the manufacturing sectors have been losing labor and still expanding output, thanks to the technological progress. Very large amounts have been spent on research and product development; and the results of this expenditure have not yet all appeared on the market. The fastest and steadiest growth in output was recorded in the service

industries, which have been absorbing all additions to the labor force; the proportion of American income spent on services has now shown a persistent rise for several decades.

30. The last five years, 1956-1960, have shown a substantially slower income growth than in the first postwar decade. Also, during the last three years the United States have developed a large deficit in their external accounts. The reasons are complex. It may well be that these two phenomena are inter-related and that the ultimate cause of the balance of payments pressure is to be found in the deceleration of U.S. growth and the corresponding lag in the adjustment of the U.S. economy to rapid output changes and relative cost reductions abroad, primarily in Western Europe and Japan. If this hypothesis is correct, the implication is that an acceleration in U.S. growth would also tend to correct, after a possible initial short-term aggravation, the balance of payments deficit as well. The assumptions - yet to be proven - are that a considerable increase in output can be achieved at lower marginal costs and that this output expansion will be accompanied by a sharp rise in the flow of profits and savings, thus enabling the United States both to improve the age-composition of the domestic capital stock and to close the external gap. Series of technological advances which have been made in recent years and which are only recently being put into operation may substantially enhance both the growth prospects of the U.S. economy and the prospects for restoring the balance of payments equilibrium.

31. Despite the fact that capital exports have been an important proximate cause of the over-all deficit, the United States have continued to provide massive foreign economic assistance. In fact, the U.S. public capital exports to low-income countries have risen substantially in the last several years. Over the long run, of course, the volume of capital outflow will have to be adjusted to the current account of the balance of payments, or vice-versa; and to the extent that the performance on current account is linked with the over-all growth of the U.S. economy, the outside world and particularly the low-income countries, have an important stake in the future trend of the American economy.

(b) Western Europe

32. Western Europe entered the postwar period with acute balance of payments deficits, an obsolete and damaged capital stock, and substantial monetary and fiscal instability. U.S. aid, extended on a large scale, financed much of the European reconstruction, which was completed in a very short span of years. Reconstruction was followed by a major economic upswing in which aggregate output increased 5% per year and per capita 4.5%. The fast rise in real income was associated with a rapid growth in export volume, averaging more than 10% annually, which helped solve the European balance of payments problem and at the same time permitted Europe to expand its imports of fuels and industrial raw materials. In response to increased income, there was a substantial rise in the rate of savings and investment (see Table X). At the end of the decade, the rate of capital formation in Western Europe averaged above 20% of gross product, higher than at any time since the First World War. The investment and savings rates in Western Europe since the mid-1950's appear to have been above the U.S. level in the same period, although these comparisons suffer from serious conceptual and statistical limitations. In any case, the rise in the European output and savings and the accompanying dramatic improvement in the balance of payments enabled the European countries to accumulate substantial amounts of gold and foreign exchange reserves. Also, several European countries re-emerged as capital exporters to the outside world.

33. On balance, the low-income countries were favorably affected by the speed of Western European growth, in the light of the heavy dependence of the European industry on outside sources of supply. European imports from low-income countries rose at a substantial rate of 6% per annum between 1950 and 1957 (current values). The value of imports in 1958 and 1959 was lower than in 1957 on account of price declines for primary products, which offset volume increases. Nevertheless, Western European imports from low-income countries in 1959 of $12.5 billion were twice as high as the U.S. imports, and some 40% above the combined value of imports of the United States, Japan and the industrialized countries in Eastern Europe (see Table XI). While generalizations are always dangerous because of the simplifications they imply, one may still venture the following statement. The rate of U.S. income growth is important for low-income countries primarily because it enables America to provide more easily the capital funds. The Western European growth has been important, at least so far, primarily because it has provided low-income countries with rising current foreign exchange earnings from their exports.

34. In one particular sector, the Western European growth had a negative impact on low-income countries. Western Europe achieved a substantial saving in imports of non-tropical food by raising its own output of such items as cereals, meat, dairy products, and fats. Pressed by early postwar shortages, Europe protected heavily its own agriculture in order to restore external equilibrium. Rapid technological advances and subsidized prices given to the farmer resulted in agricultural expansion of more than 3% per year. The advances continued even after shortages were eliminated and cheap outside sources of supply became available once again. The reduced scope for food exports to Europe affected particularly the exporters located in the temperate zone (Argentina, Uruguay, United States, Australia, New Zealand, Canada, Denmark, etc.). Also, import duties and internal taxes on some products (e.g. coffee) adversely affected growth in consumption and thus the foreign exchange earnings of the producing countries.

35. There are national and international efforts under way designed to expand Western European public long-term capital exports to low-income countries in accordance with the substantial strengthening of the European internal and external financial position. Over the short run, the success of these efforts depends primarily on factors of political nature, i.e. on the ability of the Western European governments to convince their tax-payers that more of the yearly increment to income should be devoted to foreign economic assistance. Over the long run, the volume of assistance will depend, as in the case of the United States, on the pace of Western European economic growth and on the trend in capital accumulation in the region. Both will be influenced by the final outcome of the proposed schemes to achieve greater integration of the national economies in Western Europe. These schemes will also affect the trade accounts of low-income countries, depending on the extent of protection accorded European industries and the different treatment, with respect to customs and other trade regulations, of various supplying regions outside Western Europe.

(c) The U.S.S.R. and Other Industrialized Countries of Eastern Europe

36. The rapid postwar expansion of the Soviet economy did not begin to exert a material impact on the low-income countries - other than those centrally planned - until the mid-1950's.1/ The same holds true with respect to the external economic relations of the other industrialized countries in Eastern Europe - Czechoslovakia, Eastern Germany, Hungary and Poland. Their trade with the low-income economies2/ was very small and erratic; and bent on maximum expansion of their own investment, none of the Eastern European countries engaged in capital exports to the outside world. The situation has changed since 1955. The Eastern European countries, primarily the U.S.S.R., have appeared as exporters of public capital to the low-income countries in the outside world. The main recipients have been several Asian and Middle Eastern economies. Also, there has occurred an expansion of imports from the primary producing low-income countries. In some products, these imports have become substantial, accounting for a significant proportion of total world imports (e.g. rubber, extra long-staple cotton). In aggregate terms, however, the value of Eastern European trade with low-income countries remains small compared to the trade they maintain with other industrialized regions, about 5%.3/ There is reason to believe that both capital exports and trade with low-income countries will tend to grow, although at an uncertain rate.

37. There exists a major controversy regarding the magnitude of the Soviet economic expansion. The rates of growth in output of individual products are not in doubt; what is controversial is the rate of change in major economic aggregates such as industrial output and total income. The Soviet official data claim an annual rate of industrial growth of 15% in 1948-1955 and 10.5% in 1956-1958. The estimates of Western scholars range from 8% to 12% for the period 1948-1955 (or 1950-1955); for 1950-1958, the most recent Western computation suggests an annual rate of 9%.4/ According to the Soviet official statistics, national income has risen since 1950 at a rate of about 10% per annum; the estimates of Western analysts range from 5% to 8%, but are clustered around 6-7%.5/ The reasons for disagreement with the Soviet official data are manifold: the impact of inflation on price weights for new products; changes in the comprehensiveness of statistical reporting over time; great structural shifts in output and consequently great changes in value relationships, making the use of

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1/ The impact of the U.S.S.R. on the low-income centrally planned economies (Mainland China, Bulgaria, Rumania) was exceedingly great throughout the postwar period. However, the quantitative analysis of this impact is made difficult due to lack of data.

2/ Exclusive of those centrally planned; trade with other centrally planned economies was intensive and had replaced almost fully the outside sources of supply.

3/ The combined imports of the U.S.S.R., Czechoslovakia, Eastern Germany, Hungary and Poland from low-income countries amounted to $1,075 million in 1959; the combined imports of the United States, Western Europe and Japan from the same countries totalled $20,400 million (see Table XI).

4/ N.M. Kaplan and R.H. Moresten, Indexes of Soviet Industrial Output, Santa Monica, 1959.

5/ The most recent estimate is by Morris Bornstein (A Comparison of Soviet and United States National Product, 1959), suggesting an annual rate of growth of 6.5-7.5% for 1950-1958.

any weighting system arbitrary; upward bias in the index of industrial output on account of gross rather than net (value added) valuation of output. This last defect of the official industrial index was recently discussed by one Soviet scholar; by eliminating the distortion due to the "gross" concept, he arrived at results lower than the past Soviet estimates.1/

38. The measurement problem may well turn out to be insoluble. In any case, whatever the precise figure, there is no doubt that the Soviet output growth was extremely rapid and so was the technological advance. The rate of increase in output was considerably higher than in the Western industrialized countries as a group, although probably not above that of the rapidly growing economies of Western Germany and Japan. Soviet growth had, until the last five years, the familiar pattern of rapid expansion in capital goods industry and mining, of much slower growth in the consumer goods sector, and of virtual stagnation in agriculture. Over the last five years, however, there has been a considerable expansion in consumer goods and a significant revival in agriculture. Current Soviet planning, which has been made less rigid and more decentralized than earlier, envisages a rate of increase in aggregate income and industrial output less than the official estimates of past growth (target rates for 1959-1965 are 7.5% p.a. in national income and 8.6% p.a. in industrial output). The great problem confronting the Soviet planners will be the prospective labor shortage. Another problem is the need to divert a large proportion of investible resources into residential construction, and this is already under way. On both counts, a deceleration compared to the postwar period may be envisaged, although further output expansion at a very fast rate should be expected. There has been much technological advance in the postwar period and also, new industries are expected to be established (e.g. petro-chemicals) where labor productivity is very high.

39. The postwar economic performance of the other industrialized countries of Eastern Europe has been, on the whole, less successful than that of the Soviet Union. There occurred a great expansion in base metals and capital goods, particularly steel and steel products. Agriculture, consumer goods industries and exports have lagged behind, however; and these imbalances have led to considerable economic and political stress and strain. Development has been most balanced in Czechoslovakia where the existing industrial base has been further diversified and expanded, and foreign trade sector enlarged, thus enabling the domestic industries to be supplied with imported raw materials. The rate of over-all growth in Czechoslovakia was probably not much lower than in the U.S.S.R. In contrast, substantial disproportions in sectoral rates of growth occurred in Eastern Germany, Poland and Hungary. In the latter country in particular, there was a marked neglect of the fuel, raw materials and export industries, culminating in a crisis of 1956. Since that time, there has been more balance in Eastern Europe, and the three countries have recently shown a more orderly advance in over-all output, consumption and foreign trade.

1/ S.G. Strumilin, Essays on the Socialist Economy of the U.S.S.R., 1960. As reported in the New York Times, September 11, 1960, Prof. Strumilin has estimated the rate of industrial growth for 1928-1955 at 10% p.a., compared to the official computation of 12%. His figures for 1955-1956 indicate an increase in 1956 of 8%, compared to the official index of 11%.

40. It is likely that further growth in the U.S.S.R. and in the industrialized countries of Eastern Europe will be accompanied by a rise in trade between these areas and the low income countries, provided, of course, world political conditions do not deteriorate further. There is in Eastern Europe a substantial underconsumption, in relation to per capita income, of a number of consumer manufactures and tropical foodstuffs; the latter have to be imported (e.g. coffee, cocoa, citrus fruit), and so have some of the raw materials for the consumer goods industries (e.g. wool, oils and fats). If it is assumed that personal consumption will rise in the future faster than in the past, the implication is that imports will also expand. An increase in imports on these grounds is apart from any rise which would result if comparative cost schedules were began to be taken into account in the Eastern European planning. The latter would require a considerable reorientation in resource allocation as between home and export industries, and there is as yet no certain indication that this is under way on a conscious and consistent basis and on a significant scale, at any rate not in the U.S.S.R. itself. But physical deficiencies of certain products mentioned above will tend to expand trade relations. The rate of increase must remain a major uncertainty; it will depend on the rate of growth in consumption of particular goods, and this will be determined to a large extent by planners' decisions.

41. Notmuch can be said regarding the future capital outflow from the centrally planned economies. The international political factors, which will probably be decisive, are in favor of further expansion of public loans to low income countries. The economic factors operate both ways. On the one hand, there is much to be said for a thesis that the comparative advantage for the U.S.S.R. and other industrialized countries in Eastern Europe is in the field of capital goods; and since much of capital goods exports must be done on credit, expansion of capital exports would be necessary to maximize benefits from trade. On the other hand, there is still very large demand for real capital within the U.S.S.R. itself, given the target rate of output growth and given the present program to undertake major investment expansion in Siberia and other Asian regions. In addition, of course, there is tremendous demand for investment goods in Mainland China. There is no use guessing what will be the net outcome of these various forces pulling in different directions, except to express a judgment that in the foreseeable future at least, the factors of world politics, which clearly work in the direction of expanding capital exports to low-income countries, will have the upper hand.

(d) Japan

42. One of the major economic achievements of the postwar period was accomplished by Japan. Between 1951 and 1958, i.e. after the reconstruction, the Japanese output continued to rise at a very high rate, with industrial production and industrial exports as leading sectors. Despite wide cyclical fluctuations, the average annual gain was extremely large: 7.5% in total product, almost 12% in industrial output and almost 16% in export volume (compound annual rates of growth). The Japanese gross investment was as high as 28-30% of gross product. The export orientation of the Japanese economy had its counterpart in high import propensity; and the low-income countries shared in the rise of the over-all Japanese imports. Between 1950 and 1959, the Japanese purchases from the low-income areas quadrupled. Towards the end of the period under review, Japan began to export capital, although at the same time it continued to borrow on public account on the international market. There is no reason to assume that capital exports will not rise over time, given the high savings ratio and the ability to transfer resources abroad.

Patterns of Growth in Low Income Countries

(a) The Latin American Industrialization

43. The Latin American region recorded a high rate of income growth in the postwar period, continuing the expansion which had started at the end of the depression in the 1930's. The growth was particularly fast in 1945-1955, when, as already mentioned, favorable changes in the terms of trade considerably influenced the availability of resources in a large number of countries, particularly those producing coffee and copper. While the per capita real income of the region as a whole is estimated to have increased at a rate above 3% annually, the increase in per capita output (i.e. excluding gains from improvement in the terms of trade), amounted to slightly less than 2.5% per year. The rise in output itself was substantially facilitated by rising export prices, since the latter provided resources to finance imports of capital goods and raw materials. In the majority of countries, expansion of output for the domestic market was faster than the rise in the volume of exports. Domestic expansion was the chief dynamic force; and it operated even in the absence of an expansion in export volume as long as the rise in export prices (and capital inflow) served to increase the capacity to import. The increase in aggregate output took the form of rapid industrial advance. In the area as a whole, the gross value of industrial production surpassed the gross value of agricultural output early in the postwar decade, and in the mid-1950's amounted to one-fourth of total gross output.

44. All sectors of industry shared in the postwar expansion, but at different rates. The heavy industry - consisting of base metals, metal products, nonmetallic mineral products, chemicals and paper - grew much faster than the light industry, thus indicating a rise in investment in total national expenditure and an increase in consumer durables in total personal consumption. The annual rate of growth in heavy industry output in 1948-1958 was 7.5%, compared to 3.5% for light industry. The latter had experienced fast expansion already before the war and during the war years; with the further moderate growth after the war, it had gone a long way in satisfying the requirements of the domestic market for manufactures. On the other hand, most of the expansion in heavy industry occurred in the postwar period, particularly in Brazil and Mexico, where large and diversified industrial complexes have been established, with considerable participation of foreign capital. Despite these advances, the Latin American region continues to be heavily dependent on imports of capital goods for further growth. Programs under way envisage continued domestic expansion; if realized, the Latin American steel output in 1965 is expected to surpass 10 million tons, or more than three times the output in 1957.

45. In contrast to rapid industrial advance, Latin American agriculture developed at a fairly sluggish rate in relation to domestic and export requirements: in the region as a whole, agricultural output essentially did no more than keep pace with the rate of population growth, which was, however, higher than in any other region. The relatively slow agricultural growth was also reflected in a relatively slow rise in the volume of Latin American exports and in an increase in food import requirements. In some export products, however, slow rise in exports was due to long gestation period. Once it was over, there occurred a burst of production - coffee since 1956 - which created a grave surplus situation in the producing countries.

46. The reliability of the Latin American investment figures is limited because of price distortions introduced by long lasting application of multiple exchange rate practices. Nevertheless, there should be little doubt that the investment rate in the region during the 1950's was considerably above the early postwar years or the interwar period. According to one estimate, gross fixed investment averaged 16% of gross national product in 1950-1954, compared with 12.5% in the late 1920's and even less in the 1930's (see Table XII). Other estimates are centered around 17-18% for the period 1950-1957; these presumably include both gross fixed capital and changes in inventories. If these data are good reflection of reality, the Latin American region would seem fairly well advanced in assuring its future growth, provided current internal and external financial difficulties are resolved. Postwar investment was financed by domestic savings and by capital inflow on both public and private account. A part of domestic savings was "forced" via price inflation; and a part of capital inflow was contracted on unfavorable terms, in the form of medium-term credits with short maturities. Consequently, debt service payments on loan capital showed a very sharp rise, much sharper than would have occurred, with the same amount of debt, if only the debt structure was long term. As it was, debt service payments of the Latin American countries absorbed an increasing share of domestic savings and foreign exchange earnings. Public debt service (interest and amortization) as a percentage of external earnings rose from 3% in the early postwar years to 10% in 1957-1958; and most of the increase was on account of amortization payments.1/

47. It must be stressed that all the regional aggregates quoted above conceal markedly different patterns of development in particular Latin American countries. In one group of countries - Mexico, Peru, Venezuela and several smaller economies - export volume kept pace with or increased faster than aggregate output, while savings rates either rose considerably from a relatively low base or were maintained at a fairly high level. Another group, including Brazil and Colombia, achieved very fast expansion in income, but the volume of exports lagged behind. The improvement in terms of trade (rise in coffee prices in 1946-1954) and borrowing abroad helped this group of countries to expand industrial investment. This is particularly true of Brazil which built a substantial manufacturing sector. A third group - Argentina, Chile, Haiti, Bolivia, Paraguay - was characterized by sluggish growth in per capita income, slow development or decline in the volume of exports, and by a virtual stagnation in savings.

48. Several major Latin American countries have faced substantial external financial difficulties over the last three years, 1957-1959, primarily under the impact of a fall in export prices and of heavy debt payments arising from earlier borrowing. These factors were super-imposed on pressures arising from domestic inflationary financing. Some of the countries have benefited from the cyclical recovery in 1959-1960, which has led to an increase in prices of industrial raw materials from the 1958 low levels. On the other hand, prices of foodstuffs, which are largely determined by supply conditions, have not changed much and are unlikely to do so, since these commodities are in ample supply on the world market. It must also be realized, however, that domestic policies which have frequently led to many difficulties have been undergoing a substantial change in several Latin American countries. These changes may tend to offset the influence of other factors, provided they succeed in inducing greater domestic savings and larger inflow of long-term foreign capital.

1/ For details see Dragoslav Avramovic and Ravi Gulhati, Debt Servicing Problems of Low Income Countries 1956-1958, Chapter IV (Johns Hopkins Press, 1960).

(b) Diversity of Growth Trends in Asia[1/]

49. Income growth in Asia was generally slower than in other regions, although some of the export-oriented economies - Burma, Thailand, the Philippines recorded very fast rates of increase. Agricultural production in the region did not reach the prewar level until 1950-1951. Since then, it has expanded at a rate of about 2.7% annually, i.e. above the estimated rate of population growth. The expansion in manufacturing is estimated to have been much higher, more than 7% per year. This was a combined result of rapid growth in the non-industrialized countries in the region and a continued increase in India. Pakistan established several light consumer goods industries. The Philippines, Taiwan and Malaya also set up new manufacturing lines. In India, aggregate industrial output rose 6% per year in 1953-1959; most of the increase took place in the capital goods sector, with particular emphasis on engineering and electrical goods and lately, steel. Growth in this sector of the Indian manufacturing was chiefly responsible for the over-all pattern of industrial expansion in the low income countries in Asia, with faster growth of heavy industry compared to light industry (see Chart II). However, it should be emphasized that industry in general still represents a small share of total Asian output; consequently, the aggregate rate of output growth was much more closely linked to the rate of agricultural expansion.

50. There are no estimates of the average rate of investment and savings in the region as a whole. The available data for India suggest that net investment as a percentage of national income has risen from about 6-7% in the early 1950's to 10-11% in the late 1950's. Another estimate, this time relating gross investment to gross product, indicates an increase from 9-10% in 1950-1953 to 13-14% in 1956-1958. For Pakistan, gross investment is estimated at about 10% of GNP in the late 1950's. Somewhat lower figure is quoted for the Philippines and somewhat higher for Ceylon. The available computations for Thailand suggest a rate of 14-15% and those for Burma even higher; with respect to the latter, there is a suspicion that an upward bias is introduced due to differences in pricing of various classes of products. If these data warrant any general statement, a guess could be made that investment rates in Asia have been increasing in the postwar period, but that they remain relatively low in comparison with countries at higher levels of per capita income.

51. Export growth was the chief stimulant to over-all growth in the peripheral countries of the region. Conversely, in India and Pakistan, growth forces were mostly internal. Indian output expansion was primarily designed for the domestic market: while industrial and agricultural output rose, exports developed only sluggishly. This was partly due to the rise of domestic demand for potential exports and partly to the low level of international demand for traditional Indian export products, jute and cotton. Sluggish external demand for these commodities also contributed to the stagnation of Pakistani exports. Pakistan's aggregate income was only moderately in excess of population growth: slow agricultural development was offset in moderate part by rapid industrial expansion.

1/ Exclusive of Mainland China; its developments are commented on in a note to this section.

52. The variety of economic conditions in the Asian region makes it difficult to draw any general conclusions regarding growth factors at work and regarding postwar growth performance. However, two general statements can probably be made. With some exceptions, the role of government in the investment process has been larger in Asia than in other regions; and the plans now under way continue to emphasize this role. At the same time, private industry has shown in recent years greater viability and expansionary force than was thought likely some time ago. Secondly, while the Asian countries have shown a moderate economic advance, this advance is considered by the countries concerned to be below the desired growth targets. The need for acceleration of Asian growth has been widely recognized abroad; and the substantial increase in capital flow to this area which has been under way recently indicates readiness to assist in this acceleration. On the other hand, the development problem in the over-populated regions of the Asian subcontinent is likely to prove more grave than elsewhere; and it will call for a long-term effort of great magnitude on the part of the countries concerned.

(c) Export-Induced Expansion in Africa and the Middle East

53. While the expansion of the domestic market for manufactures produced locally in the private sector has been the chief factor in Latin American growth, and while the government and private domestic investment have been the leading factors in the Asian development, the postwar expansion in Africa and the Middle East has been determined essentially by the growth of external demand for their export products. A number of countries in these two regions have experienced the "classical" development pattern, with external demand acting as the main propulsive force and with foreign capital supplying most of the required means of production in the rapidly developing export industries. It must be noted, of course, that not all countries in the region have undergone this development; a large number have remained untouched by the export growth, some have entirely stagnated and some have achieved output growth based on the expansion of the domestic market for manufactured goods. But in the majority of cases where growth of production has taken place, it has been essentially based on external market forces.

54. Middle East output of petroleum has expanded at a fantastic rate since the war; and the value of Middle East exports has increased seven-fold since prewar, faster than in any other region (see Table XIII). Operated under special profit-sharing schemes, the oil properties have yielded substantial income both to foreign capital and local governments. The amount of oil royalties collected by the Middle East authorities (Iraq, Iran, Kuwait, Saudi-Arabia, Bahrein, Qatar, and smaller sheikdoms) is now running at about $1.3 billion. While the use of this income has been only partly productive, there is little doubt that it represents a potential recurring fund which, if used properly, could be the basis for sustained and balanced growth in most of the Middle East. Oil revenue and external borrowing now serve to finance considerable investment in Iran. Even if petroleum price were to decline further, the flow of income to the Middle Eastern countries is not likely to be less than at present.

55. The two non-oil Middle Eastern countries, the United Arab Republic and Israel, experienced a development pattern based on a simultaneous growth of both manufacturing and agriculture. The rapid expansion of agricultural output in Israel was stimulated by the use of modern techniques. In both countries, manufacturing expanded at a fast rate, in Israel throughout the postwar period, in the U.A.R. with renewed vigor since 1953. In the latter country, manufacturing expansion was primarily for the domestic market, partly replacing imports and partly catering to new demands; Israel developed thriving export trade in manufactures on the growing African market.

56. The level of development on the African continent as a whole still remains very low. Also, income distribution is highly uneven as between the immigrant and the native population in the regions where the immigrant sector is of significance. In several large areas - Nigeria, Ethiopia, the Sudan, the former French West African territories, British East Africa, Federation of Rhodesia and the Republic of the Congo (the former Belgian Congo) particular regions experienced fast rates of growth, with exports as a leading sector. A large inflow of foreign capital made possible rapid expansion in the African mining industry. At the end of the postwar decade, mining output, excluding gold, was almost twice that of prewar. Ethiopia, the Congo, West African territories and British East Africa (Kenya, Tanganyika and Uganda) greatly expanded their output of coffee and were major contributors to the doubling of African production and exports in the postwar period. The value of aggregate African exports has risen five-fold compared to the prewar (see Table XIII). A number of African countries benefited from improved terms of trade until the mid-1950's. This included not only the coffee producing areas, but also those producing cocoa - Ghana, Nigeria and others in Western Africa - since their export prices were also favorable until the last few years. The postwar export expansion has not been limited to countries producing commodities enjoying strong demand on the world market (e.g. metals, coffee, cocoa.) The Sudan, producer of cotton, has also achieved substantial expansion in output. Nigeria has expanded the output and export of oilseeds, thus taking a substantial part of the earlier Asian share of the world market. Ghana utilized favorable external conditions to undertake development of home industries, and the same process is beginning to take place in other countries as well.

57. The African countries dependent on exports experienced a sharp setback in 1957-1959 due to the decline in world commodity prices. The decline affected first the metal producers; they were also first to recover as their sales improved in 1959-1960. The producers of agricultural products, similar to those in Latin America, are still experiencing low prices relative to the post-war average, and there are no indications that prices will recover appreciably in the next several years. Despite the uncertain price outlook over the medium term, it is likely that the African continent will continue to expand its export-type output. The relative lack of alternative investment opportunities in a number of countries, an ample labor supply and the availability of natural resources suitable for exports (e.g. aluminum), make such an outcome probable. On the other hand, however, there is little doubt that the new independent states will make great efforts to initiate diversification of their economies, including an expansion of their educational system.

(d) The Problem of Balance in Southern Europe[1]

58. Several Southern European countries - the underdeveloped area of the continent - have undergone a substantial economic transformation in the postwar period. All of them except Portugal have recorded a fairly high rate of growth in aggregate output; in Yugoslavia, Greece and Southern Italy, the growth per capita has exceeded 5% per year. In Southern Italy and Yugoslavia there occurred a substantial diversification of the production structures, primarily through industrial expansion. With the exception of Portugal, savings increased faster than income, resulting in a rise in the rate of investment. The economy of Turkey, after a substantial expansion in 1948-1953, developed a series of imbalances as between particular economic sectors; compounded with inflationary pressures, these imbalances checked growth in the several subsequent years and led to external financial difficulties. Growth appears to have resumed at a fast rate in 1956-1959. Greece, after a relatively slow recovery from the effects of the war, showed a fast and fairly balanced expansion in the 1950's, helped by considerable capital inflow. Yugoslavia stepped up its capital formation rate to a very high level early after the war, with special emphasis on capital goods industries and low priority to agriculture. There was a lag between investment input and increment to output, partly due to lack of domestic raw materials and imports resulting from sluggishness in the agricultural sector and export trade. The industrial expansion was resumed in the early 1950's, with foreign capital inflow assisting the investment process and the financing of current imports. By the mid-1950's industrial growth had accelerated sharply; in the mid-1950's there started an extraordinary expansion of agricultural output under the impact of more investment and other incentives. The net result has been a rise in aggregate output averaging 10% annually in the last five years, and this was accompanied by an equally high rate of growth in exports, particularly of manufactures and by a sharp reduction in imports of foodstuffs. Southern Italy benefited from large transfers of public funds originating in the highly industrialized areas in the North, in the framework of a comprehensive development program designed to reduce under-employment and to industrialize the South. Substantial overhead facilities were built and new industries established, including chemicals; at the same time, special efforts are made to raise agricultural output for exports to Northern Italy and abroad. After a long era of stagnation, income per capita in the 1950's began to rise at a rapid rate.

(e) Note on Mainland China

59. The developments in Mainland China, although still not sufficiently known, require a special comment. Substantial progress in output in both the industrial and agricultural fields has been achieved, with an estimated rate of aggregate output growth of 10% per year. The marginal rate of savings appears to have been very high; and as a result of this, the rate of gross investment in the late 1950's has been estimated at above 20% of gross product, compared to 10% in the early 1950's. It is not clear what role capital inflow from the other centrally planned economies has played in this process. While there is little doubt that there was considerable technical assistance, the size of capital flows remains uncertain. The trade returns - themselves of doubtful reliability - suggest that Mainland China was running an import surplus (i.e. capital inflow) in the early 1950's, but this was followed by an export surplus (debt repayments?) in 1955-1957.

1/ Greece, Portugal, Southern Italy, Turkey and Yugoslavia.

60. The last few years have witnessed the adoption of extremely ambitious growth targets, - much higher than attempted anywhere else. The methods applied to achieve the targets included the creation, in 1958, of agricultural production units on a scale many times larger than anything earlier attempted in the U.S.S.R. and with labor force organized in a manner similar to large military units. In the industrial field, factory output of steel and machinery was to be supplemented by cottage industry-type output. These radical changes do not appear to have accomplished the expected results, although output did accelerate in 1958. At the same time, considerable stresses and strains developed; cottage-type output of steel appears to have been of poor quality and agricultural output lagged behind the targets. The methods of mobilizing resources have been relaxed somewhat since, but at the same time, two poor agricultural years have been encountered in succession. Industrial growth at a very rapid rate appears to continue, however, supported by large-scale investment in overhead capital facilities.

V INTER-RELATIONSHIPS OF MAJOR VARIABLES

61. The purpose of this section is to set forth, in a summary form, some of the experiences of the postwar period, which may have a bearing on broad questions of economic development policy. Each of the topics mentioned below can be developed at great length; the scope of the present analysis is limited to listing them for discussion rather than providing firm answers.

The Balanced Growth Case

62. The review in Section IV of this paper has very frequently referred to the problem of balance in the postwar economic development: in many cases, the lack of balance seems to have held in check the development, at least for a time, or made it more difficult than it should presumably have been. The theory of balanced growth and the counter-theory of an "optimum degree of disorderliness" have generated much controversy in the last ten years. While they cannot be discussed here, nor all their ramifications explored, it is perhaps useful to relate them to the postwar facts.

63. Moderate imbalances may well be stimulating for aggregate growth; it is even questionable whether the fact that a particular sector is a "leader", should be called an imbalance at all, provided this leading sector finds a market for its products. However, once imbalances develop on a large scale, the aggregate growth cannot be sustained, or can be sustained only at a cost of depressing personal consumption in some products or running a deficit in the balance of payments at a higher rate than required for accelerating investment. A substantial lag in the supply of industrial or agricultural raw materials for a newly established industry can be eliminated either by reducing the rate of capacity utilization, or by pushing out exports of foodstuffs in order to acquire the raw materials abroad, or by going into debt externally in order to obtain the required foreign exchange. And conversely, consider a country which is already a large supplier of the world market in a food product for which the price elasticity of demand is low. If such a country gives a priority to further expansion of this particular product rather than to other sectors, the outcome will probably be a reduction in its aggregate foreign exchange income, at least for a time; and this reduction may then adversely affect the over-all process of growth. Both phenomena have been happening in the postwar period.

64. In this context, attention is drawn to computations reproduced in Table XIV, which shows the ratios of industrial growth rates to agricultural growth rates for a number of countries, and relates these ratios to the increase in aggregate income, for a part of the postwar period. The table indicates that industrial growth is as a rule faster than agricultural growth, confirming again the old tenet regarding the indispensability of industrialization for acceleration of economic advance. At the same time, the table indicates that, if the spread between the two growth rates becomes too wide, i.e., if very rapid industrial growth is accompanied by agricultural stagnation or slow growth, the aggregate growth rate suffers. The reason is simple: there is a lack of food for the growing labor force engaged in industry, there is a lack of agricultural raw materials for industrial growth, there is a lack of agricultural exports which have to pay for imports of capital goods and of industrial raw materials. While this case suffers from over-generalization (there is still a very good case to be made for specialization in world trade), it does help to bring out the essential need to prevent major imbalances from occurring.

International Differences in Savings Rates

65. The problem of international comparability of statistical findings presents major headaches in applied research in economic growth. Probably nowhere is this problem as acute as in international comparisons of investment rates and savings ratios. With this qualification in the background, Table XV has been prepared, showing average gross savings rates of a large number of countries, both developed and less developed, for the period 1952-1957.

66. It is a common-place to say that, in the final analysis, development depends on the country itself, on its own efforts. But this is confirmed by experience. The relative degree of effort is probably best reflected in the flow of savings in relation to income. The most striking finding which emerges from Table XV is that countries at the same or similar levels of per capita income show fairly wide differences in rates of capital accumulation. The influence of per capita income on savings cannot be denied, and it is no accident that Western Europe as a group is in the highest bracket of savings, Latin America in the medium and Asia at the lower end of the scale. But within this broad general picture there are many exceptions and very large differences. This fact by itself indicates how great the scope is for advance for any particular country.

Growth in Income and Behavior of Imports

67. Historical evidence has shown that almost any country that has achieved rapid growth in income over the long run has also experienced a steady rise in imports, which has in turn required growth in exports. The rates of growth in income and in imports have not been the same and the commodity composition of imports has changed radically over time. But, while import growth has frequently lagged, in relative terms, behind income growth and a considerable gross substitution of domestically produced goods for those formerly imported has been realized as a condition for growth, this has not meant that net import substitution has taken place. A sustained increase in income over two or more decades has always been accompanied by an increase in the absolute volume of imports.

68. We have not been able to find any exception to this rule. Even a large insular economy with a declared autarkic policy - the Soviet Union - has experienced a significant rise in the volume of imports over the long run. In the forty odd years since 1913, Soviet imports rose by more than 200%, expressed in 1950 ruble prices. Most of this increase in imports took place since the Second World War. During the three decades before World War I, United States import volume more than tripled, and import growth continued since then except during the Great Depression. In smaller economies, which are less richly endowed with a diversified natural resource base, imports usually increase faster than national income. For example, Japanese imports were only 5% of total product in the 1880's and about 20% in the 1930's.

69. Although, economic history does not know of any country experiencing net import substitution over the long run, (in the sense of an absolute decline in the volume of imports while income increases rapidly), we have been able to identify medium-term periods of five to ten years during which rapid economic growth was accompanied by a stagnating or declining volume of imports. The most remarkable case of this sort is the Soviet Union during the first two five-year plans, 1928-1937.1/ In this country, rich in natural resources and with an already existing capital goods sector of considerable magnitude, the planning authorities assigned maximum priority to the further development of this sector in order to dispense with the necessity of importing capital goods in the future. Soviet machinery output rose by about 20% per year during 1928-1937, and the volume of other producer goods (metals, minerals, fuels, etc.) by 12% annually. The share of machinery and other producer goods in total industrial output rose from 40% in 1928 to 58% in 1937. Soviet experience is instructive in showing that such a strategy might imply (a) perceptible declines in per capita consumption, particularly of food and durable goods like houses; (b) drastic changes in the pattern of investment; (c) drastic changes in the composition of imports; (d) an initial rise in capital goods imports followed by a fall; (e) straining the industrial system to the breaking point and incurring losses in terms of low productivity of individual firms.

70. Existing statistical estimates suggest that Brazil, again a large country with diversified natural resource base, is another case where considerable growth in aggregate product has occurred over medium term without any clear-cut tendency for imports to rise. This phenomenon was noticeable in the 1930's and once again in the five or six years following the import boom at the time of the Korean war. Once again, we witnessed a diversification of the industrial base with a rapid expansion of productive capacity in the machine, metal and mining industries. Capital goods and intermediate products accounted for 50% of total industrial production in 1958 compared to 34% in 1949. The share of imports in the total investment expenditures decline from 29% to 20%. Evidence on personal consumption per capita indicates a slow rise, although there might have been a decline in food items and in the living standards of particular social groups. All these conclusions are far from definite since they are based on statistical indicators which are probably distorted by the impact of inflationary pressures, multiple exchange rate practices and quantitative import restrictions. These phenomena were a reflection of heavy and continuing balance of payments pressures which have plagued the Brazilian economy throughout the postwar period. A significant component of these pressures has been a large flow of debt service payments; the lag in exports implied an extremely heavy service burden on the balance of payments.

1/ Similar development may be happening now in Mainland China.

71. It is worth emphasizing that even in these two cases import volume was kept constant only over the medium term, i.e. for a decade or less. These two cases were exceptions; in none of the countries which have grown rapidly was this experience repeated. Table XVI shows the relationship between income and import growth in a part of the postwar period (until 1955) for a number of developed and less developed countries. The main finding is that only two countries in the sample, Cuba and India, achieved net import substitution. Both these countries experienced moderate rates of income growth of about 3%; and in the case of India, net import substitution later proved highly temporary. In all other countries, postwar income growth was accompanied by considerable expansion in imports. The ratio between the rate of income and import growth ranged between 3.3 and 0.3, with a median value for the non-European countries of above 1, indicating that for an "average" country, one percentage increase in income was accompanied by more than one percentage increase in imports. The significance of this particular quantitative relationship is limited by the peculiarities of the period and countries covered; in a period in which export earnings rise fast it is only normal to expect that imports will also grow rapidly. However, the general proposition - increase in income leading to a rise in imports and thus requiring a rise in exports if the increase in income is to be maintained - is hardly open to doubt as a long-run or even medium-term phenomenon. This, of course, does not mean that economic import substitution is to be discouraged; on the contrary, this is necessary if the pressure on imports is to be reduced. And over very short periods it is possible to prevent imports from rising while still realizing a fast rate of growth in real income. But experience does suggest that export growth is still indispensable if income growth is to be sustained over the longer term, since rising exports have to pay for an unavoidable rise in imports.

3/1

POSTWAR ECONOMIC GROWTH OF LOW INCOME COUNTRIES

STATISTICAL APPENDIX

Table 1

Rates of Growth in World Manufacturing and Agricultural Output
(percent per annum, compound)

Manufacturing[a/]			Agriculture[b/]		
Period		Rate	Period		Rate
Long-run,	1870-1913	3.9	n.a.		n.a.
Long-run,	1913-1948/49	2.3	Long-run,	1913-1948/49	1.2
Short-run,	1920-1929	5.2	Short-run,	1922-1929	2.1
Short-run,	1948-1959	5.6	Short-run,	1946-1958	2.5
Short-run,	1948-1955	6.5	Short-run,	1946-1955	3.0
Short-run,	1955-1959	4.0	Short-run,	1955-1958	1.8

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a/ The period 1870-1913 includes Russia, Eastern Europe and China; the periods 1913-1948/49 and 1920-1929 exclude the U.S.S.R.; the period 1948-1959 excludes U.S.S.R., Eastern Europe and Mainland China.

b/ The periods 1913-1948/49 and 1922-1929 exclude U.S.S.R.; the period 1946-1958 excludes U.S.S.R., Eastern Europe and Mainland China.

Sources: League of Nations, Industrialization and Foreign Trade, 1945;
Ingvar Svennilson, Growth and Stagnation of the European Economy, 1955;
United Nations, Monthly Bulletin of Statistics, various issues;
W.A. Lewis, World Production, Prices and Trade, The Manchester School of Economic and Social Studies, May 1952;
Food and Agriculture Organization, the State of Food and Agriculture, 1955.

Table II

Indices of Commodity Output in Primary Producing Countries and in Industrial Countries[a] 1948 to 1955-1957

	World	Primary Producing Countries[b]	Industrial Countries[c]
Total commodity output	144	138	146
Manufacturing	158	151	159
Primary production	127	135	121

a/ Excluding Eastern Europe, U.S.S.R. and Mainland China.

b/ All areas other than North America, Western Europe and Japan and those listed in footnote a/.

c/ North America, Western Europe and Japan.

Source: United Nations, World Economic Survey 1958.

Table III

Indices of Manufacturing Output and
Annual Rates of Growth, by Regions

Region	Indices (1948=100) 1948-1955/57	1948-1959	Annual Rates of Growth (percent, compound) 1948-1955/57	1948-1959
Latin America	153	179	5.5	5.4
Aisa[a/]	180	217	7.6	7.3
Total[b/]	164	194	6.4	6.2
North America	144	154	4.6	4.0
Western Europe	184	210	8.4	6.9
Total[b/]	160	176	6.0	5.2

a/ Excluding Japan and Mainland China. The figures may have upward bias.

b/ Weighted average.

Source: United Nations, Monthly Bulletin of Statistics, August 1960.

Table IV

Postwar Rates of Growth of Real Output
in Selected Low Income Countries

Country	Period	Postwar Annual Average Percentage Rate of Growth[a] Total Output	Per Capita Output
Latin America, Total	1945-59	5.0	2.5
Venezuela	1950-59	8.3	5.1
Colombia	1945-58	5.9	3.5
Brazil	1945-58	5.3	2.8
Mexico	1945-59	5.0	2.2
Peru	1945-58	4.1	2.1
Guatemala	1952-58	4.9	1.9
Costa Rica	1950-58	5.5	1.7
Ecuador	1950-58	4.5	1.6
Panama	1950-58	4.5	1.6
Honduras	1951-59	4.5	1.5
Argentina	1945-58	3.0	0.8
Chile	1945-58	2.7	0.4
Bolivia	1950-55	1.2	0.0
Paraguay	1950-57	(probably decline)	
Asia			
Philippines	1949-59	6.3	4.1
Burma	1950/51-1958/59	4.6	3.4
Thailand	1952-57	4.7	2.7
India	1948/49-1958/59	3.1	1.8
Ceylon	1950-57	4.0	1.4
Pakistan	1949/50-1959/60	2.7	1.0
Africa and Middle East			
Federation of Rhodesia	1946-58	9.0	6.0
Israel	1950-58	12.3	4.5
Rep. of the Congo	1950-1957/58	5.3	3.1
Ghana	1950-58	4.1	2.5
Morocco	1951-58	2.9	1.4

(continued next page)

Table IV (continued)

Country	Period	Postwar Annual Average Percentage Rate of Growth[a]	
		Total Output	Per Capita Output
Southern Europe			
Yugoslavia[b]	1948-59	6.6	5.2
Greece	1953-59	6.2	5.2
Southern Italy	1950-57	5.9	5.3
Turkey	1948-58	5.8	3.0
Portugal	1948-58	3.7	2.9

a/ Compound.

b/ Material product; U.N. Economic Commission for Europe estimates GNP growth at 6.9% p.a. (per capita 5.5%).

Table V

Postwar Rates of Growth of Real Output[a] in Selected High Income Countries

Country	Period	Postwar Annual Average Percentage Rate of Growth[b] Total Output	Per Capita Output
North America			
U.S.A.	1948-59	3.5	2.8
Canada	1948-59	4.4	1.6
Western Europe, Total	1948-59	4.9	4.3
Western Germany	1950-59	8.2	7.3
Austria	1949-59	6.1	5.9
Italy	1950-59	6.1	5.5
Netherlands	1948-59	4.9	4.7
France	1949-59	4.5	3.8
Sweden	1947-59	3.8	3.0
Denmark	1948-59	3.3	2.6
United Kingdom	1947-59	2.8	2.5
Norway	1947-59	3.3	2.4
Belgium	1948-58	2.8	2.3
Switzerland	1947-59	3.2	2.0
Other			
Japan	1951-58	7.5	6.0
Australia	1947-58	5.0	2.5

a/ In the case of countries ravaged by the war, growth rates have been computed only for the period after the prewar total output was reached.

b/ Compound.

Table VI

Growth Rates in GNP or National Income

United States		Canada		United Kingdom		France		Germany		Netherlands	
Period	Growth Rate	Period	Growth Rate	Period	Growth Rate	Period	Growth Rate	Period	Growth Rate	Period	Growth Rate
					A. AGGREGATE						
1869/78-1909/18	4.3%	1870-1910	n.a.	1870-1913	2.4%	1860-1913	1.1%	1860-1913	2.4%	1900-1913	2.25%
1920-1937	2.1%	1919-1937	n.a.	1920-1937	1.65%	1924-1939	0.4%	1926-1939	3.25%	1919-1939	2.4%
1920-1929	3.9%	1919-1929	2.4%	1920-1929	1.25%	1924-1929	3.5%	1927-1929	2.0%	1919-1929	4.1%
1913-1937	2.0%	1911-1938	1.7%	1913-1937	1.1%	1913-1939	0.6%	1913-1939	1.65%	1913-1939	2.2%
1946-1953	4.0%	1946-1953	4.25%	1946-1954	2.75%	1949-1954	3.75%	1950-1954	9.0%	1948-1954	4.5%
1937-1953	4.4%	1938-1954	5.1%	1937-1954	1.75%	1939-1954	1.25%	1936-1954	2.65%	1939-1954	2.3%
1869/78-1953	3.75%	1870-1952	3.5%	1870-1954	1.85%	1913-1954	0.8%	1913-1954	1.5%	1900-1954	2.3%
						1860-1954	1.0%				
					B. PER CAPITA						
1869/78-1913	2.3%	1870-1910	2.4%	1870-1913	1.5%	1860-1913	0.9%	1860-1913	1.5%	1900-1913	0.8%
1920-1937	1.0%	1919-1937	n.a.	1920-1937	1.1%	1924-1939	0.2%	1926-1939	2.6%	1919-1939	1.0%
1920-1929	2.75%	1919-1929	0.7%	1920-1929	0.7%	1924-1929	3.4%	-	-	1919-1929	2.65%
1913-1937	0.9%	1911-1938	0.2%	1913-1937	0.8%	1913-1939	0.5%	1913-1939	1.0%	1913-1939	0.8%
1946-1953	2.2%	1946-1953	2.0%	1946-1954	2.25%	1949-1954	2.8%	1950-1954	7.75%	1948-1954	3.1%
1937-1953	3.0%	1938-1954	3.3%	1937-1954	1.25%	1939-1954	0.9%	1936-1954	1.25%	1939-1954	1.1%
1869/78-1953	2.0%	1870-1952	1.7%	1870-1954	1.25%	1913-1954	0.6%	1913-1954	0.6%	1900-1954	0.9%
						1860-1954	0.8%				

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Table VI (continued)

Italy		Australia		Belgium		Sweden		Norway		Denmark	
Period	Growth Rate	Period	Growth Rate	Period	Growth Rate	Period	Growth Rate	Period	Growth Rate	Period	Growth Rate
					A. AGGREGATE						
1860-1900	1.75%	1886-1913	3.7%	1846-1913	2.2%	1870-1913	2.0%	1900-1913	2.7%	1870/79-1905/14	3.0%
1901-1913	2.25%	1913-1938	2.1%	1913-1938	1.0%	1920-1939	2.9%	1920-1939	2.8%	1913-1938	2.1%
1918-1938	2.1%	1938-1950	2.6%	1938-1953	1.85%	1920-1929	2.25%	1925-1930	5.1%	1921-1929	2.6%
1918-1928	4.0%	1946-1952	3.1%	1948-1953	4.0%	1913-1939	2.8%	1947-1954	4.25%	1947-1954	3.5%
1913-1938	1.15%	1886-1950	3.2%	1846-1953	1.9%	1947-1954	3.5%	1900-1954	2.8-2.9%	1870/79-1947/50	2.5%
1947-1954	6.3%					1939-1954	2.5%				
1938-1953	1.8%					1913-1954	2.6%				
1901-1953	1.6%					1870-1954	2.3%				
					B. PER CAPITA						
1901-1913	1.6%	1886-1913	1.7%	1846-1913	1.4%	1870-1913	1.3%	1900-1913	2.0%	1870/79-1905/14	1.9%
1918-1938	1.2%	1913-1938	0.4%	1913-1938	0.6%	1920-1939	2.5%	1920-1939	2.25%	1913-1938	1.2%
1918-1928	3.0%	1938-1950	1.1%	1938-1953	1.5%	1920-1929	1.8%	1925-1930	4.4%	1921-1929	1.7%
1913-1938	0.2%	1946-1952	0.9%	1948-1953	3.6%	1913-1939	2.4%	1947-1954	3.25%	1947-1954	2.8%
1947-1954	5.4%	1886-1950	1.3%	1846-1953	1.3%	1947-1954	2.6%	1900-1954	2.1-2.2%	1870/79-1947/50	1.4%
1938-1953	1.25%					1939-1954	1.75%				
1901-1953	0.85%					1913-1954	2.1%				
						1870-1954	1.7%				

Table VII

Volume of World Exports, 1913-1929 and 1937-1956

Post-World War I		Post-World War II	
Year	Volume Index	Year	Volume Index[b]
1913	100	1937	100
1920	n.a.	1946	n.a.
1921		1947	93
1922	82[a]	1948	97
1923		1949	104
1924		1950	118
1925	97	1951	132
1926	96	1952	131
1927	110	1953	139
1928	113	1954	146
1929	118	1955	158
		1956	172
		1957	182
		1958	178
		1959	n.a.

a/ 1921-25 average.

b/ Excluding U.S.S.R., Eastern Europe and Mainland China.

Table VIII

Direct Impact of Changes in Terms of Trade on Growth in Income, Selected Countries

(Total Income)

Country	Period	Annual Average Growth Rate in Output a/	Annual Average Growth Rate in Income a/
Colombia	1945-55	5.4	6.7
Brazil	1945-55	5.5	6.3
Honduras	1939-53	3.0	4.0
El Salvador	1946-52	5.6	7.6
Ecuador	1950-54	4.5	6.5
Nicaragua	1948-53	8.0	9.6
Total, Latin America	1945-55	4.9	5.9
Federation of Rhodesia	1946-55	10.0	13.0
Burma	1947/48-53/54	2.5	4.0
Ceylon	1947-53	2.75	4.0
Pakistan	1950-54	(2.25) b/	(1.75) b/

a/ Compound.

b/ Crude estimate.

Note: The effect of changes in terms of trade is included in the growth in income. Consequently, growth in income (last column) is a combined result of increases in output and of an improvement in the terms of trade. (In the case of Pakistan, growth in income is smaller than growth in output, because the terms of trade deteriorated). In the case of growth in output, the effect of changes in terms of trade is excluded; consequently growth rate in output relates to changes in production only.

Source: Dragoslav Avramovic, Debt Servicing Capacity and Postwar Growth in International Indebtedness, 1958.

Table IX

Approximate Effects of Changes in Terms of Trade on Aggregate Income 1956-1958
(in percentages)

	1956	1957	1958
Belgian Congo	+ 4.5	- 7.9	- 4.7
Federation of Rhodesia & Nyasaland	- 0.6	- 4.7	- 5.2
Peru	- 0.9	+ 1.2	- 2.2
Chile	+ 1.1	- 3.3	-
Colombia	+ 3.1	- 1.5	- 1.9
Honduras	+ 1.6	- 0.3	n.a.
Costa Rica	+ 0.8	- 1.9	- 3.2
Brazil	-	-	-
Argentina	- 0.3	- 2.0	+
Mexico	- 0.5	+ 0.6	- 0.7
Ghana	- 8.6	- 1.8	+ 9.1
Ceylon	- 4.6	- 3.0	+
Australia	+ 1.4	- 2.6	- 2.1

The sign " - " indicates a negative effect on income; the sign " + " indicates a positive effect.

Table X

Gross Investment Rates in Developed Countries
(per cent of G.N.P.)

United Kingdom		Sweden		Denmark		United States		Canada	
Period	Rate	Period	Rate	Period	Rate	Period	Rate	Period	Rate
1870-79	10.5	1861-70	5.8	1870-79	15.5	1869-78	21.7	1901-10	23.3
1880-89	9.2	1871-80	8.8	1880-89	13.8	1879-88	21.0	1911-20	20.7
1890-99	10.2	1881-90	10.8	1890-99	14.9	1889-98	22.9	1921-30	17.2
1900-09	10.6	1891-1900	13.7	1900-09	16.2	1899-1908	21.5	1931-40	13.8
1904-13	9.4	1901-10	18.0	1905-14	14.8	1909-18	19.4	1947-54	21.0
1924-30	13.0	1911-20	20.2	1915-20	10.1	1919-28	20.6		
1947-54	14.0	1921-30	19.0	1921-29	10.7	1929-38	14.8		
		1947-54	19.2	1930-39	13.2	1947-51	17.4		
				1947-54	17.3				

Note: Data for U.K. and United States include both fixed capital formation and changes in inventories in all years. Data for Sweden and Canada include only fixed capital formation. In Denmark, changes in inventories are excluded.

Sources: Simon Kuznets, International Differences in Capital Formation and Financing, for the period 1870-1930. United Nations, Statistics of National Income and Expenditures, for 1947-51.

Table XI

Imports of Selected Industrialized Areas from Low-Income Countries[a]
(millions of U.S. dollars)

Importing Area	1948	1950	1957	1958	1959
OEEC Countries	n.a.	8,906	12,894	12,412	12,540
United States	4,189	5,055	6,232	5,955	6,257
Japan	207	408	1,615	1,268	1,602
U.S.S.R. and Eastern Europe[b]	(300)[c]	n.a.	911	939	(1,075)[c]

a/ All countries except the United States, Canada, Western Europe, Japan, Australia, New Zealand, Mainland China, U.S.S.R. and Eastern Europe.

b/ Czechoslovakia, Eastern Germany, Poland and Hungary.

c/ Crude estimates.

Table XII

Estimated Gross Investment Rate in Latin America

(Percent)

Year	Rate	Year	Rate
1926	12.9	1940	12.1
1927	12.4	1941	11.2
1928	13.0	1942	10.9
1929	12.8	1943	11.1
1930	11.4	1944	11.4
1931	9.3	1945	12.0
1932	8.0	1946	12.6
1933	8.5	1947	14.3
1934	9.5	1948	15.6
1935	10.2	1949	16.1
1936	11.5	1950	16.2
1937	11.9	1951	16.5
1938	12.5	1952	16.7
1939	12.2	1953	16.0
		1954	15.2

Investment in fixed capital only. Moving three-year averages.

Source: ECLA, Economic Survey of Latin America in 1954.

Table XIII

Growth in the Value of World Exports, by Regions[a]

A. In Millions of U.S. dollars

	1937	1948	1950	1956	1959
Middle East	523	1,693	2,259	3,554	3,586[b]
Africa	997	2,756	2,880	4,716	4,778
Latin America	2,310	6,534	6,739	8,642	8,255
Australia and New Zealand	855	2,142	2,179	2,663	2,822
Asia[c]	2,711	4,770	5,905	6,609	6,853
North America	4,443	16,022	13,378	24,385	23,268
Europe	10,788	18,326	20,866	38,182	45,053
Others[d]	1,558	1,758	2,431	5,879	7,245
World Total	24,185	54,001	56,637	94,630	101,860

B. Indexes (1937 = 100)

Middle East	100	324	432	680	686[b]
Africa	100	276	289	473	479
Latin America	100	283	292	374	357
Australia and New Zealand	100	251	255	311	330
Asia[c]	100	176	218	244	253
North America	100	360	301	549	524
Europe	100	170	193	354	418
World Total	100	223	234	391	421

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a/ Excluding U.S.S.R., Eastern Europe and Mainland China.
b/ Excluding Iran, which exported $500 million in 1956.
c/ Excluding Japan.
d/ Including Japan.

Middle East: Egypt, Iraq, Iran, Israel, Kuwait, Lebanon, Saudi-Arabia, Sudan, Syria.

Africa: Algeria, Angola, Belgian Congo, Ethiopia, Federation of Rhodesia, French Cameroons, French Equatorial Africa, French West Africa, Ghana, Kenya, Morocco, Nigeria, South-West Africa, Tanganyika, Tunisia, Uganda, Union of South Africa.

Latin America: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Cuba, Dominican Republic, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay, Venezuela.

/continued next page

Table XIII (continued)

Asia:	Borneo, Burma, Cambodia, Ceylon, Hongkong, India, Indonesia, Korea, Laos, Malaya, Pakistan, Philippines, Taiwan, Thailand, Viet-Nam.
North America:	U.S.A., Canada.
Europe:	Austria, Belgium-Luxembourg, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, United Kingdom, Yugoslavia.

Source: Computed from I.M.F., International Financial Statistics, various issues.

Table XIV

Relationship Between Postwar Growth in Total Income, Growth in Industrial Production and Growth in Agricultural Output a/

A. Growth in Industry more than Twice as Fast as Growth in Agriculture

Country	Ratio of Growth Rate in Industry to Growth Rate in Agriculture b/	Growth Rate in Total Income b/
Pakistan	23.2	1.75
Argentina	above 10	2.2
Japan	8.5	8.4
Austria	3.4	7.4
Sweden	3.4	4.3
South Africa	3.4	4.0
Colombia	2.9	6.7
West Germany	2.5	9.3
Norway	2.5	3.5
Netherlands	2.3	4.5
Brazil	2.0	6.3
Italy	2.0	5.5

B. Growth in Industry less than Twice as Fast as Growth in Agriculture

India	1.9	3.2
United Kingdom	1.9	2.9
France	1.6	4.8
Finland	1.5	5.1
Peru	1.5	5.0

C. Growth in Industry Approximately Equal to Growth in Agriculture

Mexico	1.1	5.3
Belgium	1.1	3.5
Philippines	1.0	6.4
Denmark	1.0	2.6

a/ Growth rates in income (last column) relate to periods ending around 1955. Growth rates in industrial and agricultural output, from which the ratios have been computed (second column), also relate to the first postwar decade. Due to statistical limitations, however, the periods are not exactly identical, and therefore the ratios shown (and their comparison to income growth rates) are only a very crude indication of sectorial relationships.

b/ Compound.

Table XV

Gross Savings Rates of Selected Countries (as % of Gross National Product)

Period 1952-57 except where otherwise stated

25% and upwards	Less than 25% - 20%	Less than 20% - 15%	Less than 15% - 10%	Less than 10% - 5%
Australia	Austria	Argentina	Cuba	Chile
Finland	Canada	Belgium	Ceylon	Greece
Germany, Fed. Rep.	Iraq (1952-56)(?)	Brazil	Ecuador	Haiti (1953-55)
Iceland	Peru (1952-56)	Burma	Ghana	Ireland
Japan	South Africa	Colombia (1954-57)	Guatemala	Libya (1957-58)
Luxembourg	Sweden	Costa Rica	Honduras	Pakistan
Netherlands	Venezuela	Denmark	India (1951-57)	Panama (1953-56)
Norway		Dominican Republic	Malaya (1952-53)	Paraguay (1957)
Yugoslavia		El Salvador	Nicaragua	Philippines
		France	Portugal	
		Italy	China (Taiwan)	
		Mexico	Thailand	
		Morocco (1952-56)	Turkey (1951-55)	
		Spain (1954)	U.A.R. (Egypt)	
		United Kingdom	Uruguay	
		United States		

Sources and Notes. Data have been derived from the UN Yearbooks of National Accounts Statistics (last issue 1958) with the exception of the following countries, for which data were derived from reports and opinions of IBRD Staff members, and other sources as stated: Colombia, El Salvador, India (Wilfred Malenbaum - India and China: Contrasts in Development Performance, American Economic Review, June 1959, pp. 284-309), Jordan, Libya, Nicaragua, Pakistan, Paraguay, Thailand, United Arab Republic - Egypt (Economic Developments in the Middle East, 1956/1957, Supplement to World Economic Survey 1957), Uruguay, Yugoslavia.

The savings rates are believed to be subject to relatively wide margins of error, limiting their value for inter-country comparisons. These errors are due to differences in coverage, in quality of the underlying statistics, and to differences in the price structure of the various economies. Also, savings rates in general are not measured directly, but are arrived at by combining investment and balance of payments data (savings equal investment plus balance on current account).

Table XVI

Postwar Annual Growth Rates in Import Volume and Their Relationship to Income Growth a/

Country	Import Growth Rate	Income Growth Rate	Ratio of Import Growth Rate to Income Growth Rate
Europe			
Denmark	10.6	2.6	4.0
Netherlands	11.9	4.5	2.6
Finland	12.0	5.1	2.4
Norway	7.7	3.5	2.2
Iceland	11.4	5.5	2.1
Turkey	10.3	5.1	1.9
Italy	9.2	5.5	1.7
W. Germany	15.3	9.3	1.7
United Kingdom	4.5	2.9	1.6
Belgium	5.2	3.5	1.5
Austria	10.5	7.4	1.4
Sweden	6.1	4.3	1.4
France	6.5	4.8	1.4
Yugoslavia	4.0	4.9	0.8
Non-Europe			
Ecuador	21.6	6.5	3.3
Australia	11.6	5.0	2.3
Costa Rica	11.2	5.5	2.1
Belgian Congo	14.4	7.0	2.1
Colombia	12.1	6.7	1.8
Ceylon	6.7	4.0	1.7
Burma	6.6	4.0	1.7
Chile	4.7	2.9	1.6
Nicaragua	11.8	9.6	1.2
Egypt	2.4	2.9	0.8
South Africa	2.4	4.0	0.6
Panama	1.3	2.3	0.5
Argentina	1.0	2.2	0.4
Philippines	1.6	6.4	0.3
India	0.8	3.2	0.3
Cuba	-0.6	3.0	b/

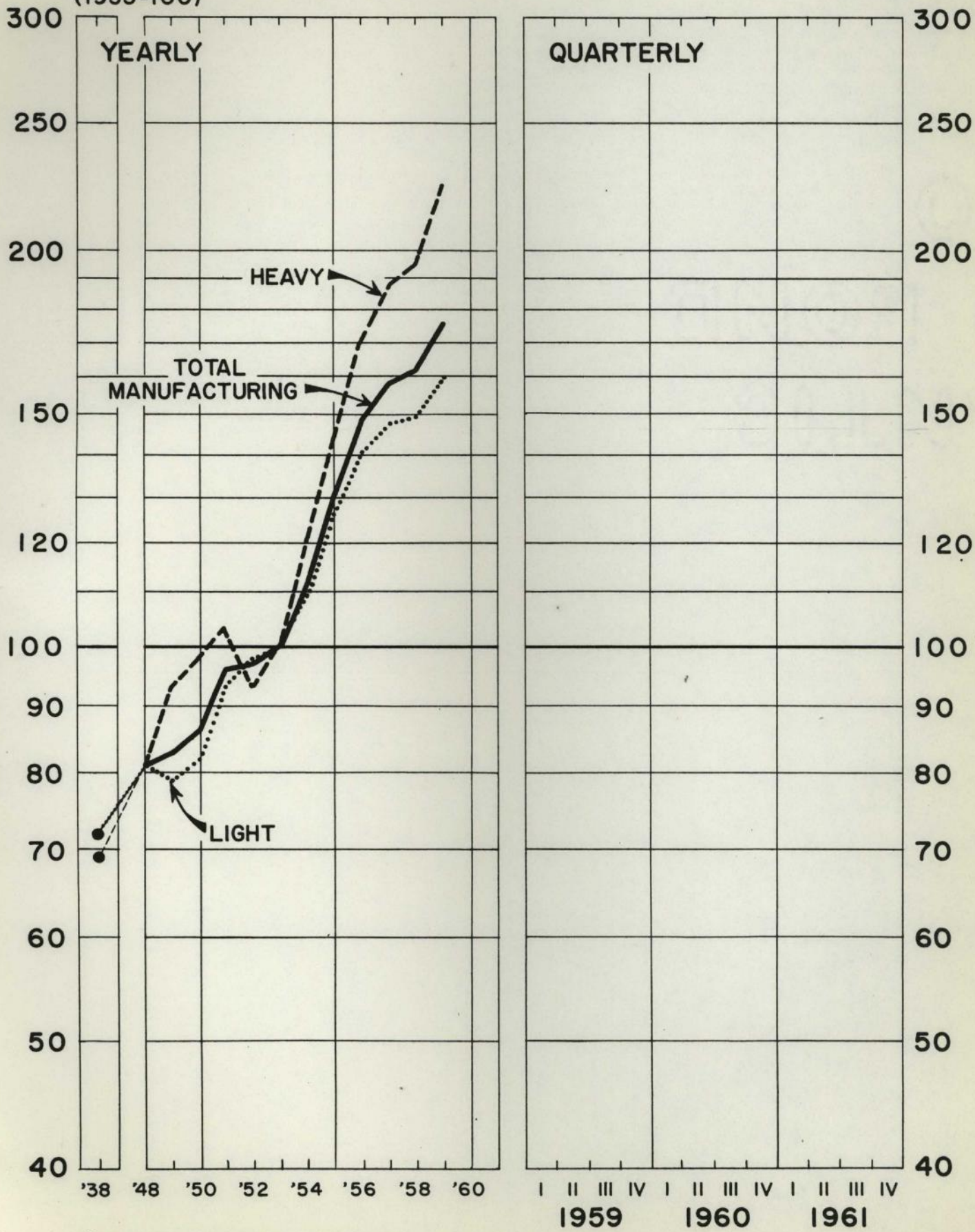
a/ Growth rates in income (third column) relate to the period ending around 1955. With minor exceptions, growth rates in import volume (second column) have been computed for the same period.

b/ Decline in imports; rise in income.

Source: Dragoslav Avramovic, Debt Servicing Capacity and Postwar Growth in International Indebtedness, 1958.

ASIA* : MANUFACTURING INDEX

(1953=100)



*Excludes Japan and mainland China.

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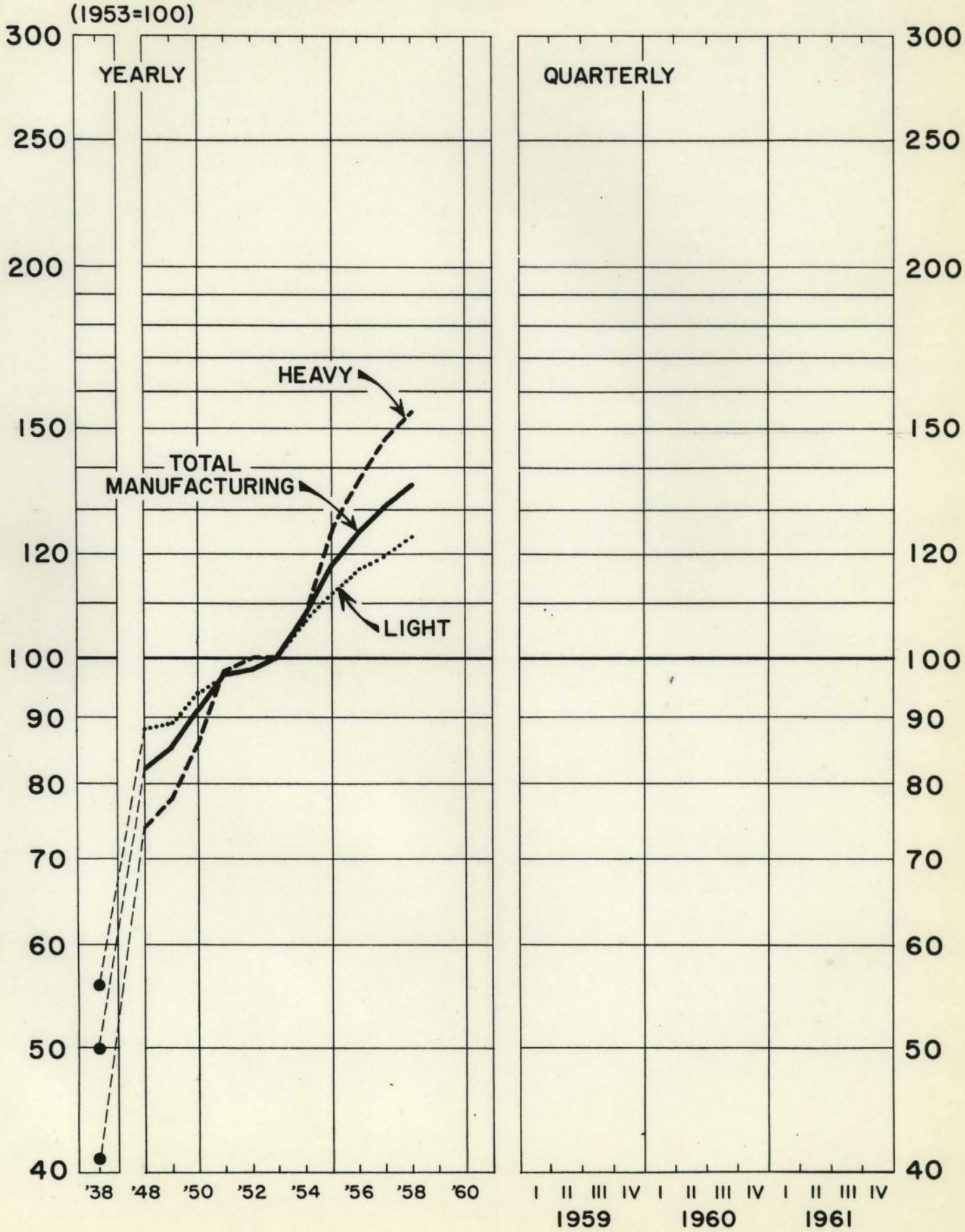
LATIN AMERICA: MANUFACTURING INDEX



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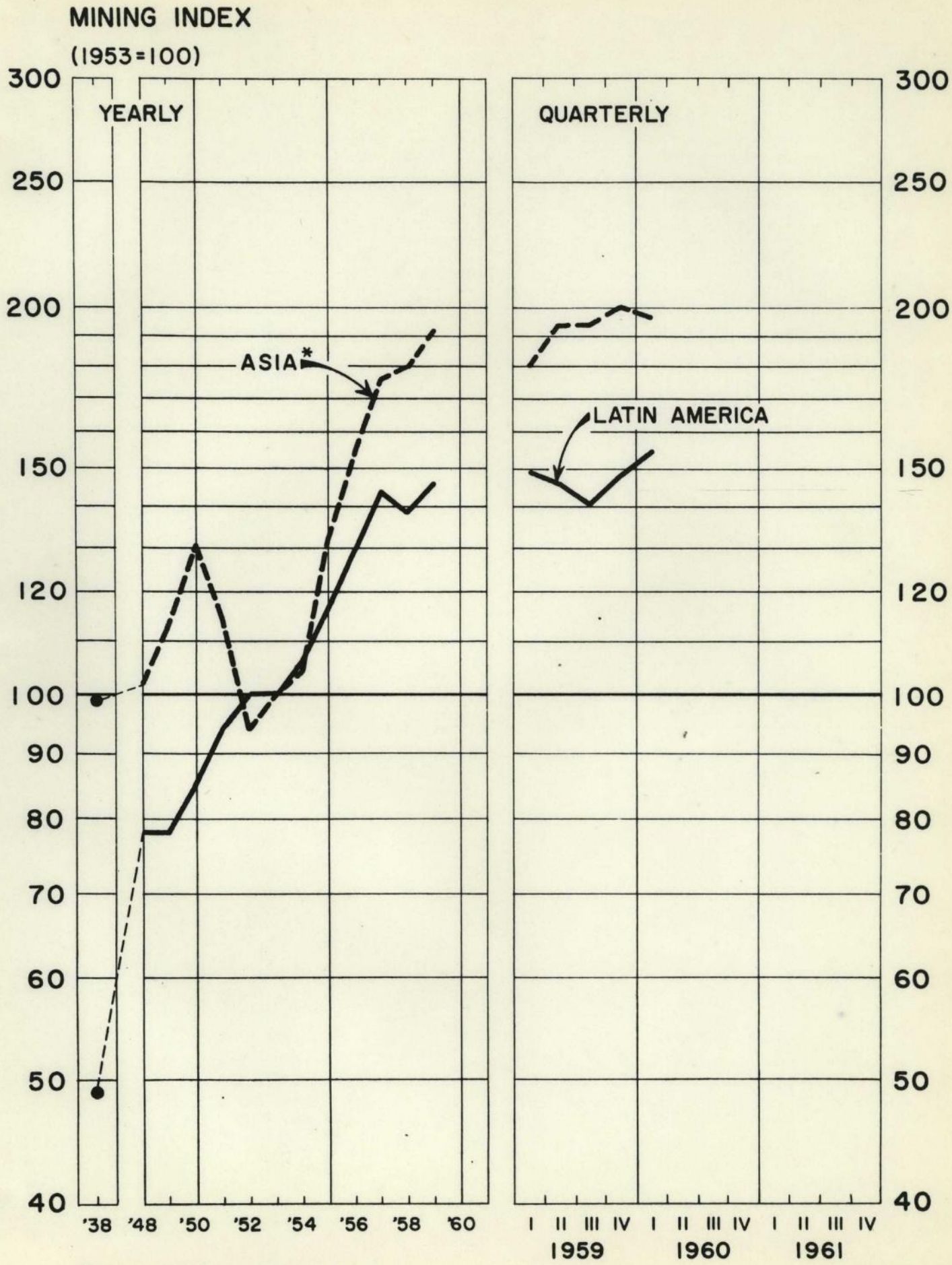

*Excludes Japan and mainland China.

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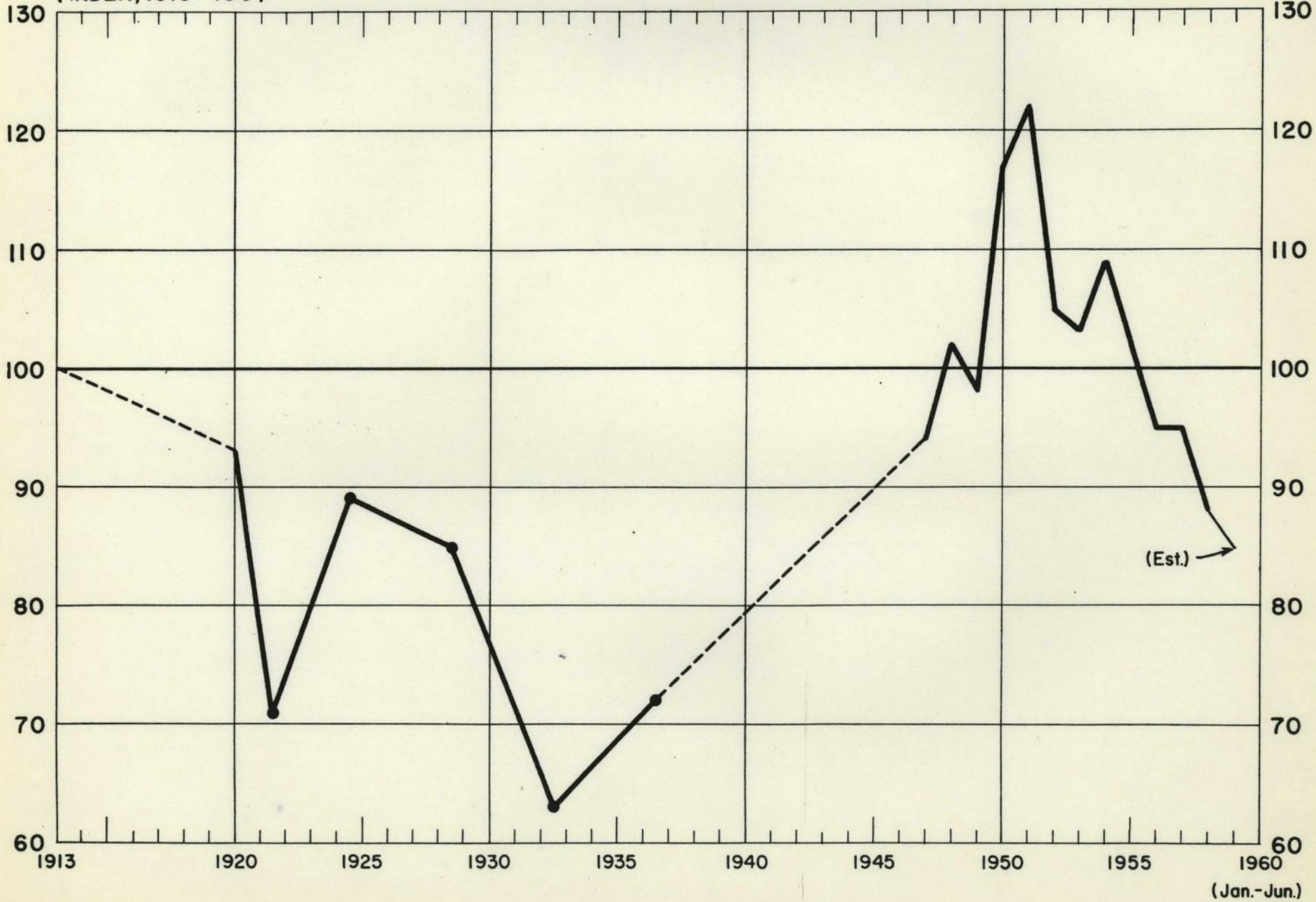
TERMS OF TRADE OF AGRICULTURAL PRODUCTS IN WORLD MARKETS
(INDEX, 1913 = 100)



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Extract in Aside File

Influence of Debt Burden and the Problem of Flexibility

Dragoslav Avramovic
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April 1965

Influence of Debt Burden and the Problem of Flexibility

Dragoslav Avramovic
Director, Special Economic Studies
International Bank for
Reconstruction & Development

I. Introduction

1. The large expansion of international capital flows which took place over the last fifteen years was accompanied by a substantial increase in international indebtedness, especially on public account. The developing countries were virtually free of debt as the Second World War ended. At the end of 1963, their aggregate public and publicly-guaranteed indebtedness, including short-term obligations on which payments were delayed and the obligations to the International Monetary Fund, was of the order of $30 billion.1/

2. Growth in outstanding indebtedness and in debt service payments was particularly fast since the mid-1950's. A sample of 37 developing countries, including the most important debtors and accounting for almost three-fourths of the population of all developing countries 2/ owed about $7 billion on public account at the end of 1955 (debts with an original maturity of one year and over, i.e. exclusive of short-term obligations as well as of obligations to the IMF). By the end of 1963, their aggregate public and publicly-guaranteed debt of this type reached $21.5 billion - a yearly growth exceeding 15%. Debt service obligations of the same group of countries and with respect to the same category of debt, rose from $0.7 billion in 1956 to $2.8 billion in 1964, a four-fold increase in eight years.

3. The rise in the volume of financial transactions and the increase in indebtedness of developing countries have been striking features of the postwar economic scene; and it is virtually certain that these features will continue to characterize the world economy for a long time to come.

II. Factors Underlying Growth in External Debt

4. This expectation is based on the hypothesis that most of the developing countries will need foreign capital for a substantial period in the future. International indebtedness, its level and its growth, reflect the cumulative resource gap, changes in it over time and the terms on which external funds needed to fill the gap are made available. The larger the initial resource gap, the longer the period needed to close the gap, and the higher the rate of interest on borrowed funds, the higher the level of indebtedness and the level of the associated debt service.

1/ IBRD, Economic Growth and External Debt, Volume II, The Johns Hopkins Press, 1964.
2/ Excluding the centrally planned economies.

A. The Debt Cycle

5. The length of the borrowing period, the behavior of capital inflow and the size of indebtedness and of debt service can be illustrated by what may be called a debt cycle. Three stages can be distinguished in such a debt cycle; and they are closely linked with the course of economic development.

6. In the first stage, as investment increases, savings, starting from a low level, are inadequate to finance domestic investment requirements. A country has to borrow not only to finance part of the investment, but also to meet amortization charges and to pay interest on the debt that is accumulated in the process. In this way, it obtains a net addition to its domestically generated resources available for investment. During this stage the burden of servicing foreign capital is continuously postponed. Debt increases very rapidly: since interest on debt incurred previously is paid out of new borrowing which also carries interest, the familiar law of compound interest operates in all its force. However, if an adequate proportion of the newly generated income can be saved, the country would, over time, meet an increasing share of its investment requirements from its own domestic resources.

7. The second stage begins when the savings have grown sufficiently to provide for all domestic investment requirements. In this stage, savings would not, however, be sufficient to meet the entire additional burden of interest and amortization payments on accumulated debt. At the beginning of this stage, debt would continue to grow, but at a slower pace than in the first stage. Towards the end of the second stage, debt has reached its peak and ceased to grow, as savings cover not only the domestic investment requirements but also the entire interest burden on external debt.

8. The third stage is one of declining indebtedness. The savings generated in the economy are sufficient to finance not only all domestic investment and interest payments on external debt but also provide a surplus to retire the debt. Gross borrowing continues for some time, but at a decreasing pace. As gross borrowing approaches zero, the external debt declines rapidly.

9. Chart I shows the three stages of the debt cycle. A growth model, showing the inter-relationship of the target income growth rate, the investment rate, the productivity of capital, the savings rate and the volume and terms of capital inflow, has been used for purpose of illustration. Income growth target is set at 5% p.a.; the initial average gross domestic savings rate is postulated at 10% and the marginal gross savings rate at 20%, i.e. double the average. The gross incremental capital-output ratio is assumed at 3:1 and the gross investment rate at 15%. Foreign capital inflow initially finances one-third of gross investment. It is borrowed at an average interest rate of 6% per annum and average maturity of 15 years, terms fairly representative of conventional lending.

10. With these values for the variables and starting from zero debt, the debt cycle lasts 36 years. The phase in which indebtedness rises lasts about 25 years. This period of rising indebtedness has two stages. During the first 15 years, the country obtains net addition to domestic resources, on top of repayment and interest; in the subsequent decade, borrowing takes place to meet service requirements (see para. 7 above).

B. The Problems of Productivity and Savings

11. Whether the model variant is representative of reality crucially depends on whether the values for the return on capital (measured here in macro-economic terms by the numerical relationship between capital investment and output generated, i.e. by the incremental capital-output ratio) and for savings rates are properly selected. The debt cycle would last considerably longer if the return on capital is lower than implied in the incremental capital-output ratio of 3:1 and if the initial savings rate is below 10% and the marginal savings rate below 20%. And conversely, the period of external borrowing would be shorter and the indebtedness level lower if the producticity of capital is higher and if the income plough-back rate is raised above 20%.

RELATIVE MOVEMENT OF RESOURCE GAP, NET CAPITAL INFLOW AND GROSS CAPITAL INFLOW – THE "MODEL" CASE

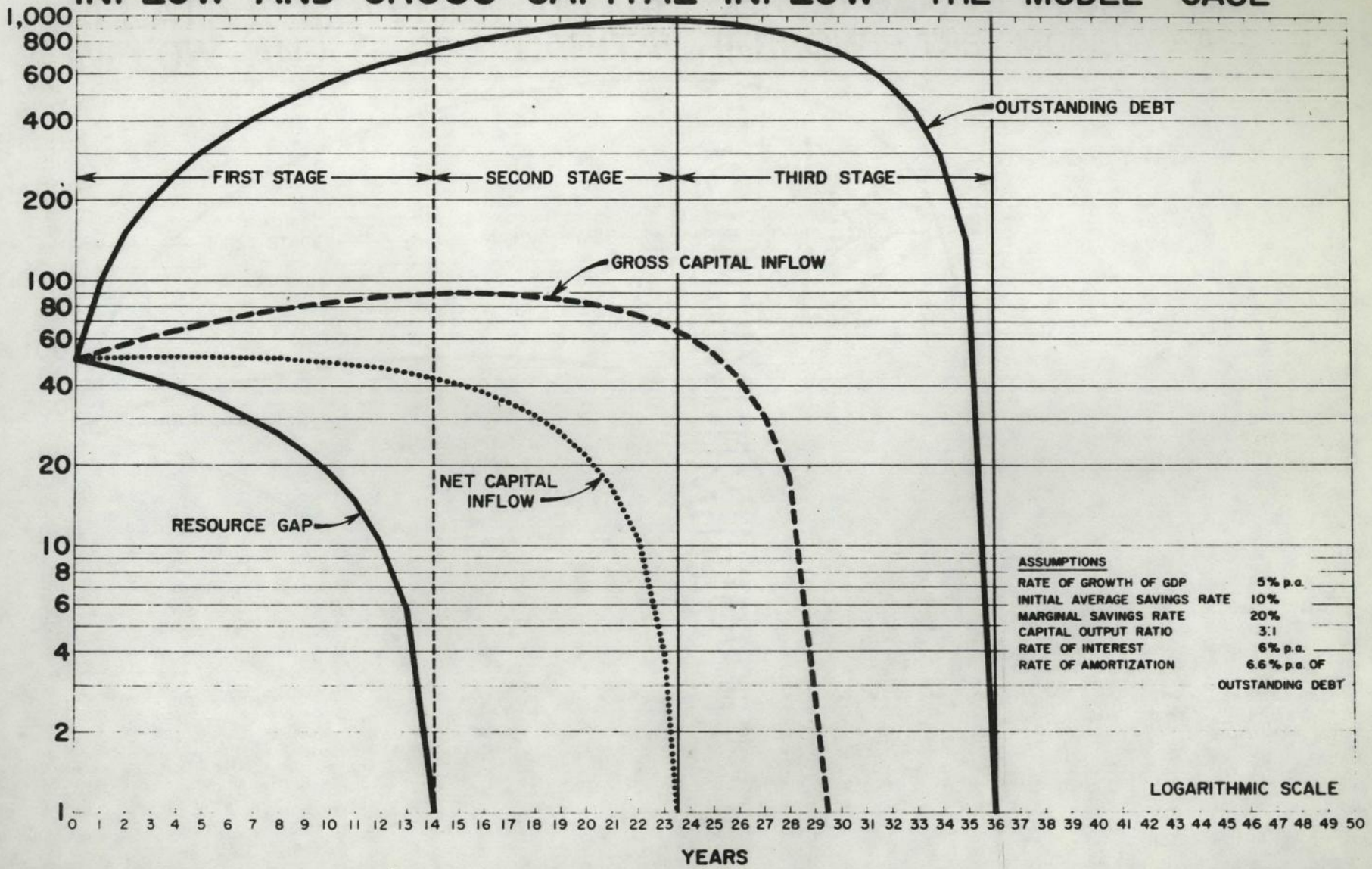

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CHART I

12. The relationship between capital investment and output generated is determined by a number of factors: the availability of human skills, the capacity to combine and organize the factors of production in an optimal fashion, natural resource endowment, the sectoral distribution of investment, the rate of capacity utilization, the durability of assets created by investment. A number of these factors are structural in nature and require considerable time and effort to change; and the very fact of underdevelopment may put a country in a disadvantageous position with respect to one or more of these factors. While we have assumed for purposes of illustration a relationship of 3:1 between capital invested and gross annual output generated, in a number of developing countries this ratio has been higher (i.e. the return on capital lower) than this value. A relatively high ratio of capital investment to output - i.e. low returns to capital in terms of value added - implies a greater demand on resources, domestic and foreign, to maintain a particular growth rate and thus a longer period of borrowing and a higher level of indebtedness.

13. The low level of per capita income implies a low initial savings rate. In a number of very poor countries, this rate is below the 10 percent level; consequently, their initial investment-savings gap may be larger than one-third assumed in the model variant, provided, of course, that the absorptive capacity permits a gross investment rate of 15% or higher. On the other hand, for an appreciable marginal savings rate (rate of ploughback of new production), it is essential that not only the total production should be increasing, but the per capita output should be rising fairly rapidly. Since the rate of population growth in most of the developing countries ranges between 2-3 percent per year, the rate of growth in per capita income is correspondingly reduced. Under these circumstances, it may take some time to attain a marginal savings rate of 20% or so. The implication is that external indebtedness in these cases would continue to rise for a period beyond the quarter of a century, assuming the values of the other variables unchanged.

C. The Foreign Exchange Problem

14. In addition to the two constraints discussed above - the constraint on savings and on the return on capital - there is the third one affecting the developing countries: the foreign exchange constraint. The low-income countries are producers of primary products. Consumption of some of these rises very rapidly. Some, however, are victims of Engel's Law of Consumption: their use may be declining, relatively or even absolutely, as income of consumers increases. Some are being displaced by technologically superior and cheaper substitutes. As a result, international demand for the majority of primary products increases at a slower rate than imports of materials and equipment needed to sustain a satisfactory growth in real income. Lagging exports limit the rate of growth of income, since they limit the capacity to import the investment goods needed to expand the capacity to produce; and the limit to the rate of growth of income makes it difficult to raise the rate of savings, particularly when the initial level of per capita income is low. Consequently, these countries have to develop exports of manufactured products and of service activities for which international demand rises relatively rapidly; alternatively, they have to embark upon a program of accelerated import substitution.

15. The problems of adjusting to the country's own growth requirements as reflected in growing demand for imported goods, as well as the problems of adjusting to structural changes in the world economy, are not confined to less developed countries. The difference between the dilemma of primary producers and that of industrialized countries is in respect of the required period of adjustment. Factors are much more mobile, institutions much more adaptable and skills are much more widespread in advanced, diversified and industrialized countries than they are in the underdeveloped world. The more severe the foreign exchange constraint and the more stringent the limits to which the rate of savings can be pushed in a low-income country over a certain period, the greater the required capital inflow and the longer the period of external borrowing for a given income growth target.

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16. The possible impact of the limitations to obtaining a high productivity of capital and rate of ploughback is illustrated in Chart II. It depicts a stylized "long-haul" case in economic development: it is assumed that the low level of per capita income, the high rate of population growth, the obstacles to productivity of capital and the constraint on export growth tend to prevent a sharp increase in the marginal savings rate. Even in this case, the latter is substantially above the average; but instead of being postulated at double the average (see para. 9), it has been assumed at 60% above the average. A comparison of the projections in the "model" case and in the "long-haul" case shows that the variation of the marginal savings rate from 20 percent (Chart I) to 16 percent (Chart II) more than doubles the period required to close the domestic resource gap. Further, in the "long-haul" case, the build-up of interest payments and external debt is so rapid that gross capital inflow is a continuing phenomenon and never ceases. The country has become self-sustained, in the 37th year, in terms of the basic relationship between its domestically generated savings and domestic investment requirements; but it has remained a dependent economy in terms of continuously rising debt to infinity, as long as the conditions defined on Chart II prevail. In cases of this sort, financing of economic development cannot take place on conventional terms if the breakdown of the growth-cum-debt mechanism is to be avoided.

17. At the opposite end are countries where conditions are very favorable: output grows fast, the ploughback is large and increasing, the rate of return on investment is high, the composition of output responds quickly to external demand conditions and to the country's growth requirements. In such a country the conditions are such that the debt cycle would be completed faster than indicated in Chart I. Paradoxically, it may so happen that the stage sequence of the cycle does not take place because the borrower has been too successful. Foreign investors are eager to employ their funds in this country because returns are large and secure. A country which has fully succeeded in the growth process may not reduce its indebtedness for a long time, i.e. the third stage of the cycle may be postponed for a long time. Its position is analogous to that of a successful corporation whose debt grows with its own growth.

III. The Liquidity Aspect of the Debt Servicing Burden

18. On balance, it can be argued that the majority of developing countries are facing a fairly long period in which they will need large external resources to fill their savings and foreign exchange gaps. If this is accepted, it follows that their debt service liabilities will also tend to increase over a long period. Furthermore, if most of the capital inflow is contracted on a fixed servicing schedule, i.e. as loan capital, most of the debt service obligations become contractually fixed.

19. The debt servicing problem is essentially the problem of reconciling competing claims on resources. The payment of debt service implies that the borrowing country has to forego a certain amount of purchasing power, which could otherwise be used for consumption or investment. This is the cost of foreign capital to the national economy: against this cost there is the benefit which was derived from foreign resource inflow in the past in terms of an increase in the rate of capital formation, and also the benefit which may be expected in the future from further capital inflow.

20. The problem of reconciling competing claims on resources has a different complexion, depending on the time horizon under consideration. At a point of time, or in a short period, debt servicing difficulties take the form of a liquidity crisis in the balance of payments. Fixed debt service liabilities, if they are of a large magnitude, introduce a serious element of rigidity into the debtor's economy. Since the economic system, and particularly the foreign exchange receipts, continue to fluctuate, while debt servicing obligations remain contractually fixed, the entire impact of downward fluctuations must be borne by imports or the country must run a deficit in the current balance of payments. How successfully will a debtor cope with such a liquidity crisis depends on the relative strength of the elements of rigidity (i.e. the contractually fixed external obligations, minimum tolerable level of imports) and countervailing elements of flexibility (i.e. availability of compensatory finance, inessential imports). It also depends on the skill of the authorities of the debtor country in managing the balance of payments.

RELATIVE MOVEMENT OF RESOURCE GAP, NET CAPITAL INFLOW AND GROSS CAPITAL INFLOW - THE "LONG-HAUL" CASE

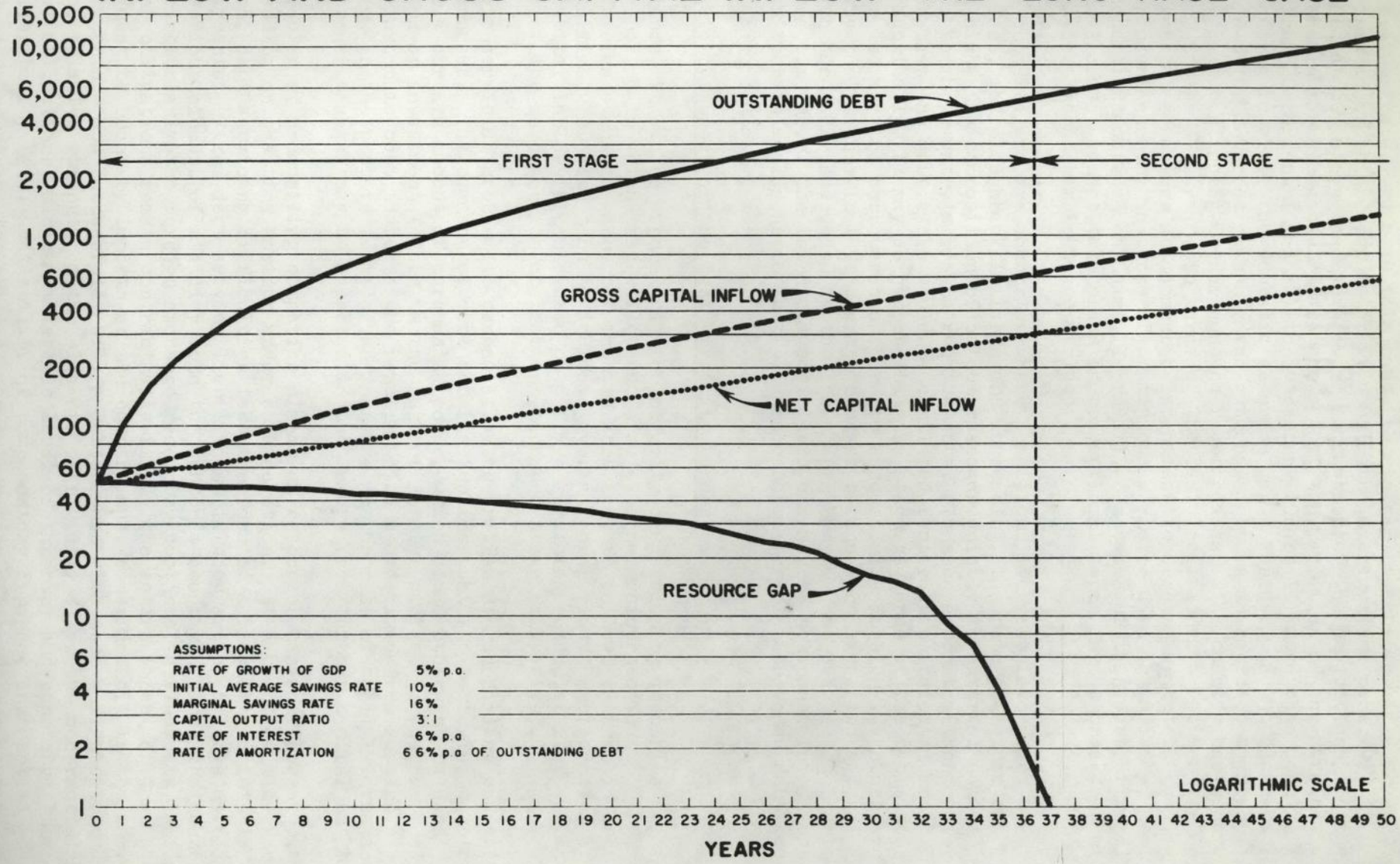

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CHART II

21. Difficulties in transferring debt service payments at a point of time may result from cyclical or accidental fluctuations in exports, capital inflow and imports, or from capital flight or a bunching of repayment maturities. Alternatively, the liquidity crisis may be a symptom of structural weaknesses of the economy. Frequently, it is a combination of transitory disturbances and long-term factors.

22. From the long-run viewpoint, the crucial factor in the debt servicing problem is the rate of growth of domestic output: reconciliation of competing claims on resources is much easier when total resources are growing than in a stationary economy. As long as the incidence of debt service falls on a part of the increment in per capita income, it is possible for consumption and nationally financed investment to rise pari passu with debt service payments. And if the rate of increase in real income and savings, remaining available after the claims of foreign capital have been met, is reasonably high; if growth occurs in a continuous fashion; if the country has succeeded in removing or at least alleviating the foreign exchange constraint; and if the benefits of growth are widespread, it can plausibly be argued that the opportunity cost of fulfilling external obligations is less burdensome than in a situation in which service payments impinge on existing living standards and employment levels.

23. However, even in a successful long-run growth-cum-debt case, liquidity difficulties may occur and they may be very serious. If the debt structure is unfavorable (i.e. if a large proportion of the total debt is repayable in a short period), if compensatory facilities are insufficient and if export declines, even temporary, are violent - the debt servicing problem may be formidable although the long-term trends of savings, investment and exports may be perfectly consistent with self-sustained growth and may indicate a successful completion of the debt cycle. The balance of payments pressure occurs here just as much as it occurs in the "long-haul" case. The difference between the two cases is that in the pure "cash-squeeze" case the liquidity difficulties are temporary and they may be remedied through an extension of grace and maturity periods on new loans and through rescheduling of maturities on the existing debt. In contrast, in "long-haul" cases, these measures may not be sufficient, since the source of debt servicing difficulties goes deeper. The cash squeeze here is primarily a function of continuously rising interest payments on a continuously rising debt, rather than of bunching of maturities in a short period or of a temporary export decline.

IV. The Problem of Rigidity

24. Inflexible obligations are potentially dangerous under any circumstances. This danger was present even in the classical system of foreign investment in earlier periods of economic history. The unmitigated violence of the international business cycle, at that time, frequently created havoc in international investment. There were, however, two redeeming features. Foreign private direct investment which accounted for a considerable share of total flow, was concentrated heavily in activities producing primary products for exports; and as export sales fluctuated, so did profits in export industries. The other redeeming feature was the complex inter-relationship of interest rates, risk premia and the anticipated behavior of debtors in periods of crisis. It was expected that borrowing governments would default occasionally on their fixed-term loans, when a depression or other causes reduced exports and budgetary income; but to offset this, debtors were charged an interest rate which included a risk premium high enough for the lenders to feel that foreign investment was a worthwhile proposition.

25. The present situation is different from that described above. A major part of private direct investment still flows to export industries in less developed countries. The return flow of profits from these "enclave" investments fluctuates pari passu with export sales. But another part of foreign direct investment in the developing countries now goes into industries that produce goods to replace imports. Domestic demand for

these products is increasing rapidly and without much fluctuation. Consequently, profits also tend to increase as the volume of domestic sales expands; and the less fluctuations there are in this rising domestic market, the smaller will be the fluctuations in the profits earned by foreign-owned companies.1/

26. The above is one illustration of a much wider problem. Most developing countries now consider the acceleration of economic growth a major task facing the present generation. The responsibilities of governments in promoting investment and faster growth are greater today than they were, on the average, in earlier periods. Therefore, there is demand for massive capital inflow from abroad, and the major channels through which this inflow is transferred are governments in developing countries, which either borrow on their own account or guarantee loans to private parties. The return flow on this capital is fixed: it is loan capital that is borrowed. And as capital inflow proceeds, these contractually fixed obligations also increase. True, debtors are now in a better position than they were in earlier periods, because the rates of interest in international lending are now kept at a relatively low level. The lenders, or more accurately, their governments have assumed the risk of default. But precisely because most of capital flows are under governmental control and sponsorship and because interest rates are relatively low, debtors are not expected to default. The net result is a continuing increase of indebtedness and of debt service charges predominantly of a fixed nature.

A. Disturbance Variables

27. The size and the gravity of the payments problem which debt countries facing a fixed servicing schedule may encounter at a point of time, depend on the value and inter-relationships of a number of variables. Three of these variables may be called disturbance (fluctuating) variables: exports, capital flows and emergency and inflation-induced imports.

28. A major element of balance of payments vulnerability of most developing debtor countries arises from instability of export earnings. Short-term declines in these earnings have in the past originated largely in cyclical declines in international demand. In addition, there have been falls in export receipts caused by occasional natural failures in supply. Further, a number of developing countries have experienced reduced earnings over the medium term, originating in excess production of primary products in relation to demand.2/ Finally, export declines have been caused by domestic policies which have adversely affected the incentives to produce for exports or to sell on the international market.3/

29. How far does the experience of the recent past provide a guidance to the future? Falls in exports caused by breakdowns of supply are likely to continue. The problem of medium-term supply-induced fluctuations still exists in all its intensity, and it can be solved only if an advance is made in systematic diversification of the production and export structures of countries heavily dependent on products experiencing medium-term production cycles and if these countries undertake some measure of international coordination of their investment programs and achieve further progress in their joint export sales strategies. Export declines resulting from domestic measures having a restrictive effect on export sales are likely to be less frequent than in the past: in a number of developing countries there is an increasing realization of the

1/ See S. Shahid Husain, Relationship Between the Fluctuations in Export Earnings and Direct Investment Income Payments - A Statistical Test in IBRD, Economic Growth and External Debt, Volume III, 1964.

2/ The best example is the coffee crisis after the mid-1950's.

3/ For a detailed appraisal of factors causing export declines and export instability generally, see IBRD, The Commodity Problem, 1964, a paper submitted to the U.N. Conference on Trade and Development.

need to adopt policies stimulating export growth within the constraint given by the absorptive capacity of the international market. With respect to demand, it would seem that violent business fluctuations, so significant in the prewar period, are not likely to recur: since the Second World War, the industrialized countries have successfully controlled the forces underlying the "normal" business cycle. This does not mean that the problem has been solved, however. Cyclical variations in demand and in business activity in the major world industrial centers still exist, although their amplitude has been dampened; and these cyclical swings lead to alternating upward and downward multi-year price movements which affect all or most commodities simultaneously.1/

30. The second source of instability is to be found in the capital account. Until the Second World War, capital flows were by far the most sensitive element in the total payments picture, reacting violently to the ups and downs of the business cycle. During a depression, the liquidity problem, frequently originating in the current account under the impact of an export decline, was most seriously aggravated by cessation or even the reversal of capital flows.

31. International capital flows to developing countries as a group have displayed a great degree of stability in the postwar period. The largest component of these flows consists of funds provided by national and international lending agencies; and these funds have not been sensitive to cyclical fluctuations. Frequently, they have tended to compensate for the declines in export receipts.

32. This stability in the over-all flow, however, has not always meant stability for individual recipients. Government-to-government flows are sensitive to non-economic factors affecting bilateral relations. Private direct investment has continued to fluctuate in response to changing conditions in both the capital-importing and capital-exporting countries. Suppliers' credits are sensitive to the short-term balance of payments position of the borrowing country: the terms may become progressively disadvantageous as the liquidity crisis approaches, and the flow is likely to cease when payment difficulties become severe. Thus, despite the stability in the aggregate flow and even in the flows to individual countries recorded thus far, for the majority of countries, it is not in present circumstances possible to forecast with precision and for a longer period the prospective level and fluctuations of capital imports and the terms on which they will be available.

33. Swings in the flow of foreign capital are not the only disturbance in the capital account of developing countries. Another disturbance which can be of great importance in some countries in particular periods, is flight of domestic capital. It is frequently caused by political factors; but it can also be caused by monetary developments. Countries which have experienced bursts of inflation and successive devaluations would be particularly exposed to capital flight.

34. Domestic inflationary pressures affect not only the capital account but they cause disturbances in the current account as well. Import increases are a natural consequence of inflationary finance if the exchange rate is pegged. There has been an increasing awareness in the developing countries of the consequences of inflationary finance in the recent past; however, it would probably be too optimistic to expect that inflationary pressures will not recur. The impact of this source of instability can be reduced if the balance of payments management is flexible; but even so, a high and continuing degree of inflation will make the external financial position increasingly difficult over time, particularly if capital flight ensues.

1/ In the postwar period, a commodity price cycle can clearly be established. The Commodity Boom lasted from the end of the war through the mid-1950's. It was followed by the Commodity Slump in the years 1956-1962. The Price Recovery started in late 1962.

35. Some of the disturbance variables discussed above are beyond the control of the debtor country: this refers in particular to export fluctuations that are induced by swings in international demand and to autonomous changes in foreign capital inflow. And conversely, domestic authorities can exercise substantial influence on some of the variables: this refers to inflation-induced increases in imports and reductions in exports and to capital flight. Only a combination of domestic policies geared to a minimization of internally generated disturbances and of international policies aimed at stabilization of receipts from commodity exports and from capital inflow can assure that the development process proceeds without interruption and that debt servicing obligations are discharged smoothly.

B. Offsetting Variables

36. As an alternative to stabilization of receipts from exports and from capital inflow, there are three ways in which the impact of export declines and of swings in capital inflow can be offset. The debtor country may build up its foreign exchange reserves in periods of export upswings and use them in periods of decline. Secondly, compensatory finance from abroad can be provided on a loan or grant basis to offset the effects of declines. Thirdly, the debtor country may find it possible to curtail its imports of non-essential goods in periods of decline and thus continue its growth process, although personal consumption, or its growth, may have to be curtailed.

37. In countries where export receipts fluctuate over a relatively short period, if the government of a country conducts an anticyclical policy and has perfect foresight, it may take advantage of a period of above trend exports to accumulate international reserves and pay off short-term debts, and would thus be prepared to face a period of below trend exports. Such compensatory policy has been in evidence in some developing countries since the war. But this has not been a general rule. With emphasis on economic development and growing need for investible resources, the opportunity cost of maintaining foreign currency and gold reserves has risen, and a number of countries have partly run down such reserves for financing domestic capital formation. In others, reserves have been used to finance excessive import increases: periods of above-trend exports have also been periods of high consumption and investment expenditures, and optimistic expectations regarding the duration of high prices, coupled with imperfections of the monetary mechanism and monetary policies, have occasionally led to excessive spending and thus to excessive imports. Finally, in another group of countries, the very fact that export declines have lasted a long period, has made it impossible to carry out a systematic reserve policy: reserves have been spent in the initial period of the decline and it has proved impossible to rebuild them while the decline has continued. Whatever forces have been at work, the fact is that reserves of developing countries are now substantially smaller, in relation to imports, than they were fifteen years ago; consequently, their own ability to weather a crisis wihtout substantially reducing consumption and investment has been reduced.

Reserves a/ as Percentage of Imports b/

	All developing countries	Latin America	Asia
1948	70.0	44.0	86.9
1953	56.6	46.1	53.7
1958	42.7	33.2	34.2
1963	39.2	28.1	32.0

a/ Gold, Fund Gold Tranche Position, Foreign Exchange.
b/ Commodity Imports.

38. Countries' own reserves are not the only offsetting variables. Compensatory borrowing abroad is an effective supplement of own reserves; and the operations of the International Monetary Fund have to a certain extent reduced the need to maintain large reserves of gold and convertible foreign currency. The lack of flexibility introduced by the reduction of own reserves has thus been partly compensated by the establishment and activity of the international machinery specifically designed to supplement the nationally-owned supply of liquidity facilities. Recently, the Fund introduced a new compensatory facility to offset fluctuations in export earnings: this facility is directly aimed at primary producing countries suffering from temporary short-falls in export earnings.

39. The Fund is not the only source of compensatory finance: national lending agencies in some developed countries engage in these operations and also, there is a flow of private funds, of limited magnitude, available to a few developing countries.

40. It is natural that compensatory financing is not available without limitations: these limitations operate with respect to both the amounts that can be drawn and the conditions under which drawings can be made. Furthermore, it is in the nature of "conventional" compensatory financing that it is repayable over a relatively short period. This raises serious questions concerning the position of countries whose export declines may last a long time-span. More generally, repayments by countries which will be net importers of capital for a long time, will inevitably have to be financed out of new gross capital inflow.

C. Rigid Variables

41. It has already been emphasized that the fluctuating nature of external receipts of debtor countries stands in sharp contrast to the fixed nature of their debt servicing obligations. Interest on external debt is the most rigid element in the balance of payments. It is contractually fixed and is a recurring charge on the economy regardless of borrower's fortunes. Fixed interest debt in most developing countries consists today largely of public and publicly-guaranteed debt. Consequently, any failure to pay this recurring charge adversely reflects on a government's ability to save and to transfer savings, and thus inevitably undermines its credit standing.

42. From the viewpoint of the balance of payments, service on loan capital borrowed by private parties is equally rigid. On the other hand, it is usually assumed that returns on equity capital fluctuate with export earnings. As indicated in para. 25, this assumption is only partially valid: it applies to profits and dividends originating in export industries, but it does not apply to earnings of foreign investment employed in activities catering to the domestic market. In the postwar period, such foreign investment has been of significance: it has been flowing not only into consumer goods industries but also into industries producing capital goods and intermediate products in a number of industrializing developing countries.

43. The implication of this development is that a change in the economic structure, which will have favorable long-term effects, has been accompanied by an increase in the short-run rigidities in the balance of payments of the countries concerned. Their exports still consist of primary products which continue to fluctuate, while returns on foreign capital originate in a rising and barely fluctuating market. Furthermore, the proportion of interest and dividend payments in total export earnings is bound to increase during the initial stages of economic development of most countries if this development is financed by capital inflow to any considerable extent: given the constraint on international demand for primary products, export earnings are unlikely to increase faster than 4% per annum, while debt service liabilities tend to build up at a much more rapid rate if lending takes place at conventional or even half-

conventional terms.1/ And the higher the proportion of loan capital in total capital flow, the greater the proportion of domestically-oriented industries in the total equity stock held by foreign investors; the greater the constraints on international demand for primary products and the greater the fluctuations in the prices of these products - the more significant will be the element of rigidity.

44. The other component of debt service payments - amortization - is also a rigid element in the balance of payments, although it could be argued that there is a substantive difference between this element and interest. It is the exception rather than the rule that the less developed countries are expected to reduce the absolute level of their debt in the near future, which would happen in the case of net repayment. However, there is no certainty, under present conditions, that new loans will be extended and thus offset or more than offset payments due on the loans of the past. The contractual obligation to pay amortization exists irrespective of what happens to other elements of the balance of payments. The irony of the situation is that precisely when a country is facing liquidity difficulties, creditors, faced by unpaid or delayed bills, may feel compelled to refrain from rolling over old debts and extending new credits.

45. The most severe liquidity crises are caused by the concentrations of maturities in a short period - the so-called "cash squeeze" cases (see para. 23). If the debtor country has to repay a large proportion of its debt within a few years; if no foreign exchange reserves have been accumulated to enable the retirement of the debt; and if the creditors are not willing to undertake the refinancing of the debt - liquidity difficulties will be acute. Creditors may be reluctant to reschedule the debt over a longer period because of their past experience: rescheduling would not help much if the debtor were to pile up new short-term debts as soon as the existing ones have been funded. On the other hand, the debtor country, if it is unable to space over time the maturities, is almost compelled to resort to more short-term borrowing, frequently at prohibitive interest rates. Its debt structure worsens further. Breakdown is avoided if the debtor country drastically curtails its imports and thus releases resources for the liquidation of short-term debts; this helps restore its credit abroad, but in the meantime the process of economic growth is arrested. Alternatively, creditors may agree to postpone collections, and this provides a breathing spell. But if the postponement is only for a few years, a new liquidity crisis occurs in short order. This succession of crises inevitably affects the flow of long-term capital needed for development. The solution of the "cash-squeeze" problem is unlikely to prove lasting unless an advance is made in coping with the basic factors responsible for the financial crises that have been experienced.

46. An unfavorable debt structure does not necessarily lead to a liquidity problem: whether such a problem will in fact arise depends on the size of service payments in relation to the major macro-economic variables, particularly export earnings, and on the possibilities of contracting new capital inflow. The latter cannot be statistically measured; they will depend on the circumstances in particular cases. The former can be expressed in the form of the debt service ratio.

1/ If net transfer of resources of 1,000 units takes place every year (net of amortization and interest), debt service payments will show the following values in the 20th year of borrowing:

Interest Rate %	Repayment over (no. of years)	Debt Service		
		Interest	Amortization	Total
6	15	2,026	3,480	5,505
6	40	2,026	1,019	3,045
3	15	754	2,674	3,428
3	40	754	774	1,528
0.75	50 (of which 10 years of grace)	153	93	245

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RATIOS OF DEBT SERVICE PAYMENTS TO GROSS DOMESTIC PRODUCT, SAVINGS AND EXPORTS

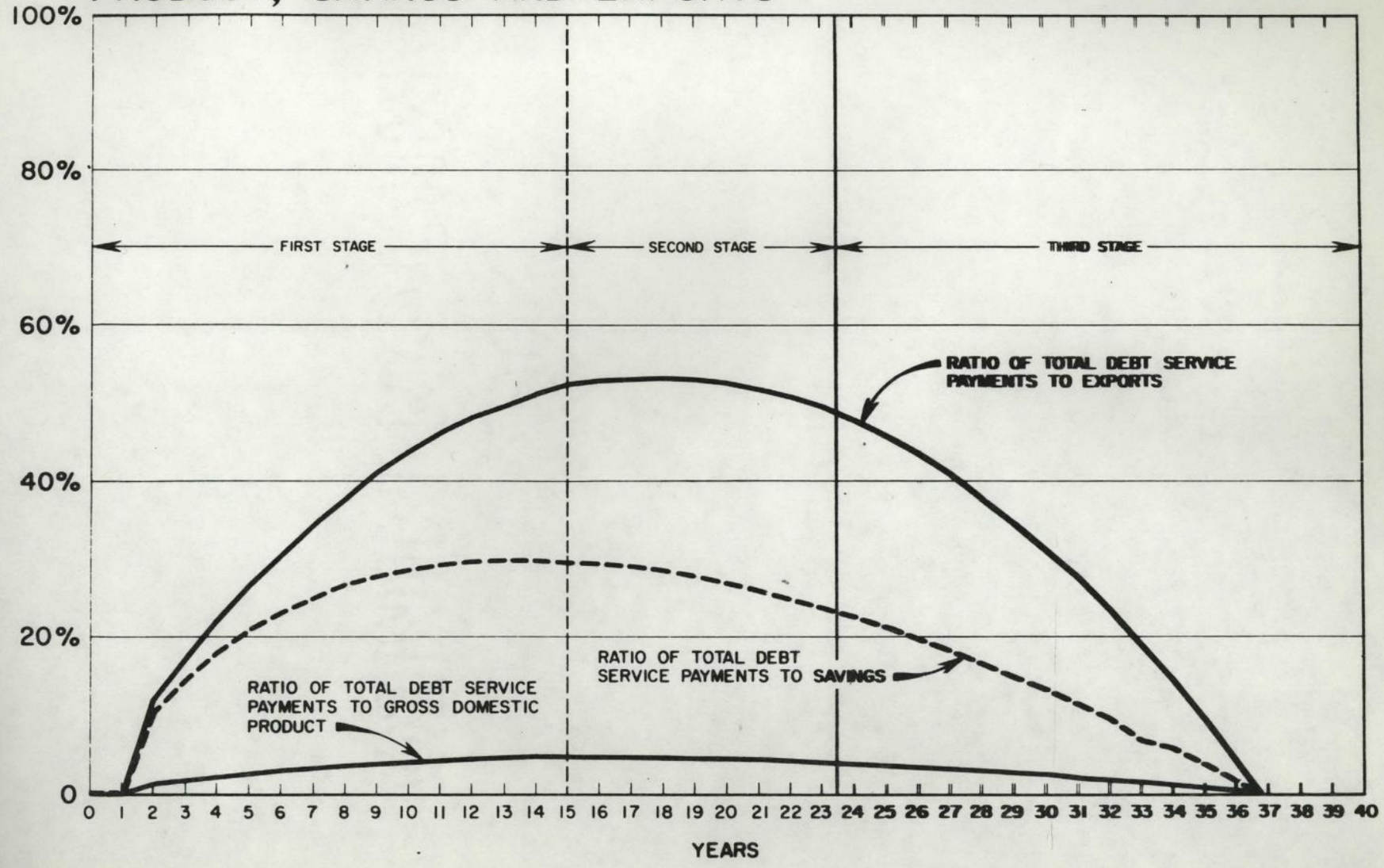

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CHART III

D. Debt Service Ratios

47. A convenient indicator of rigidity and of the actual and potential pressure on the balance of payments is the ratio of debt service - interest and amortization - to exports. Foreign exchange is one of the scarcest, if not the most scarce, inputs for the developing countries. The debt service is a continuing charge against this scarce resource. The proportion of exports absorbed by debt service reflects the pressure to which a debtor country would be exposed and the effort it would have to make if capital inflow were to cease. Furthermore, since current account receipts also fluctuate, debt service ratio indicates the potential strain which a debtor country would experience when its exports contract: the proportion of export earnings absorbed by debt service would go up when exports decline and there would occur a proportionate reduction in the amount of foreign exchange available to the country for financing imports needed for domestic consumption and investment.

48. The rigidity in the balances of payments on account of public debt service has increased for almost all countries included in the sample. The increase in rigidity - and its general level - would be even greater if the ratios included the service on private loan transactions, investment income payments generated in foreign-owned industries catering to the domestic market and obligations on account of commercial arrears.

49. The debt service ratios can attain very high values in the course of the debt cycle. If foreign capital is lent on conventional terms, if the domestic growth variables have the values as described in the growth-cum-debt model (see para. 9), if the initial ratio of exports to income is 10% and if exports grow at the postwar historical rate of 4% per annum, the debt service ratio would reach 50% at the peak of the debt cycle, i.e. one-half of exchange earnings would be absorbed by debt service (see Chart III). This is a high degree of rigidity. It should be emphasized, however, that if the proportion of exports to total income is higher than 10% - i.e. the economy is more "open" - the level of the ratio would be lower than indicated in Chart III. Further, to the extent that lending takes place at a rate of interest below 6%, the ratio would be correspondingly reduced. Finally, in the context of short-run analysis, the impact of a high level of the ratio in the period of crisis may be offset by a high level of exchange reserves and of other compensatory facilities.

50. Debt service is not the only element of rigidity in the balance of payments of a developing country. As its industrialization process proceeds, the composition of its imports undergoes significant changes. Expansion of the industrial base requires expanded imports of fuels, raw materials, spare parts and capital goods. Reduced imports of these goods may cause unemployment and affect the momentum of growth. Furthermore, the postwar period has been characterized by a rapid expansion of the imports of foodstuffs into developing countries: domestic food supplies have lagged behind increasing demand. Reduced imports of staple foods is rendered extremely difficult: imported food, in most cases, serves to supplement local supplies to urban centers whose population has grown rapidly since the war. Experience suggests that there are severe limitation to the possibilities of reducing food supplies to these centers.

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Proportion of Exports Absorbed by Public Debt Service a/
(Debt Service Ratios) 1956 and 1963

	1956	1963
Argentina	1.9	18.3
Bolivia	4.1	23.0
Brazil	12.2	23.8
Chile	9.2	19.1
Colombia	6.5	23.1
Costa Rica	4.3	12.7
Ecuador	5.5	13.6
El Salvador	1.3	3.5
Guatemala	0.2	7.7
Honduras	-	3.0
Mexico	11.3	30.0
Nicaragua	7.6	5.9
Panama	2.9	7.4
Paraguay	14.5	8.8
Peru	9.6	10.8
Uruguay	5.4	7.8
Venezuela	0.3	4.3
India	0.9	14.5
Iran	1.2	6.4
Israel	51.4	33.8
Pakistan	6.2	13.9
Burma	n.a.	3.7
Ceylon	0.7	2.3
Malaya	0.6	1.2
Philippines	1.9	8.8
Thailand	1.5	4.2
East Africa b/	4.4	7.6
Ethiopia	1.1	7.7
Federation of Rhodesia and Nyasaland (former)	3.8	8.3
Nigeria	0.6	5.7
Sudan	0.2	7.8
Turkey	n.a.	42.1
Yugoslavia	17.3	17.2

a/ Service on public and publicly-guaranteed indebtedness with original maturity of one year or more.

b/ Kenya, Tanzania and Uganda.

V. Some Implications

51. The rigidity phase in the development of debtor economies is a temporary phase if the growth-cum-debt process is successful. The critical questions concern the length of the period of rigidity and the policies which the debtor countries pursue. While there is a tendency for imports to be concentrated on the most essential items and the demand for imports is strong as a result of income growth targets, this can be further intensified by inflationary domestic fiscal and monetary policies which are frequently pursued irrespective of the phase of the price cycle and the state of external accounts. Inflationary policies, of course, interfere with a smooth reconciliation of domestic and foreign claims on aggregate domestic output; and this can be translated into debt servicing difficulties.

52. We do not know how long it takes a developing country to overcome the worst phase of the strains on its balance of payments. In particular, we do not know at what speed an industry which has been built initially to supply the domestic needs, can be made sufficiently competitive to penetrate the international market. Sooner or later, if economic growth is a success, the structural change of the economy will inevitably lead to a structural change in external accounts, with a consequent rapid rise in exports and a relaxation of rigidities. There are industrializing countries which have accomplished the transition from domestic to export orientation swiftly, in about a decade or so. Their experience should be carefully studied.

53. The problem of rigidities arising from debt servicing burden can be handled in a number of ways. An acceleration in the rate of growth and structural change of the borrowing countries, accompanied by maximum inducement to export development, will tend to increase the flexibility of their economies. Flexible balance of payments management will make it possible to accommodate more smoothly the competing claims on resources and thus to maintain the debt service flow. Elimination of barriers facing the exports of developing countries, both of primary products and of manufactures, will enable these countries to raise their rate of export growth and thus to reduce the adverse impact of the foreign exchange constraint. Reduction in the amplitude of fluctuations of primary product prices will alleviate the difficulties arising from the varying nature of external earnings of developing countries against which they face fixed repayment obligations. Softening of the terms of capital inflow would reduce the rate of growth in external indebtedness and in debt service payments and thus reduce the debt servicing burden and the accompanying rigidities to which it gives rise.

April 1965

F. Avramovic - Speeches

Mr. Lind
Mr. Graves
~~Mr. Fulton~~
Mr. Bennett
Mr. Chicco

January 3, 1967

Dear Mr. Wionczek:

I am sending you attached the updated version of the study "Commodity Problem" as you have requested. I am agreeable to your publishing it in your monthly review and also in your volume of essays.

I am now leaving for Rio de Janeiro where I shall be heading the Bank's Economic Mission during the next two months. This will give me the direct insight into the Latin American debt problem - the subject to which I intend to come back to after my return.

If you want to write to me in Brazil, I shall be staying at the Leme Palace Hotel, Rio.

With best wishes for the next year,

Sincerely yours,

Dragoslav Avramovic
Director,
Special Economic Studies

Attachment.

Mr. Miguel S. Wionczęk
Adviser
CEMLA
Durango Num. 54
Mexico 7, D. F.

cc: Mr. Harold Graves

Avr/cnm

Feb 1965 Coffee Annual

Coffee Problem: An Agenda for the Future

Dragoslav Avramovic
Director, Special Economic Studies
International Bank for
Reconstruction & Development*

No. 1 Commodity Problem

Coffee occupies a special place in the economies of developing countries. With export sales of $2-2.5 billion annually, it is the second largest commodity moving in international trade, after petroleum. A larger number of developing countries depend on coffee as a major earner of foreign exchange than on any other product. Coffee has been a relatively profitable commodity over the long run. World consumption has trebled since the 1920's, the value of world coffee exports is now very much higher than before the war and in a number of developing areas it is the first cash crop to be introduced.

At the same time, coffee exhibits, in many ways, the worst features of the commodity problem. The price and the foreign exchange earnings of the producing countries fluctuate wildly over the short run, in response to yearly swings in production, typical of the tree crops. These yearly fluctuations are super-imposed on prolonged cyclical movements in the world coffee economy, spanning about 20 years each. Relatively brief periods of shortages and high prices alternate with extended periods of surpluses and depressed markets. Finally, there is also a structural problem. As coffee can be easily and profitably grown in vast areas across the tropical belt, and as other investment opportunities in these areas are limited at the present stage of their development, new coffee producers have been entering the world market with substantial quantities. Since this has not been accompanied by a sufficiently fast development of alternative investment and employment outlets in the economically more advanced coffee-producing countries, there has occurred a continuing competitive struggle among old and new producers. They compete for a market whose absorptive capacity, circumscribed in part by tariffs, taxes and quantitative restrictions, has been increasing over the long run, but at a rate lower than the world capacity to produce.

Each major primary product presents a problem. The peculiarity of coffee is that it contains a conundrum of problems. In a very few other commodities are the effects of inevitable natural disturbances so powerfully magnified by reactions of the market and particularly of the producers; in an even lesser number of commodities are the resulting price movements so violent; and no other major internationally traded commodity is so strongly influenced by diverse production and sales policies of so many governments.

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* The views expressed in this paper are those of the author's and should not be taken as representing the views of the International Bank for Reconstruction and Development and its affiliated organizations.

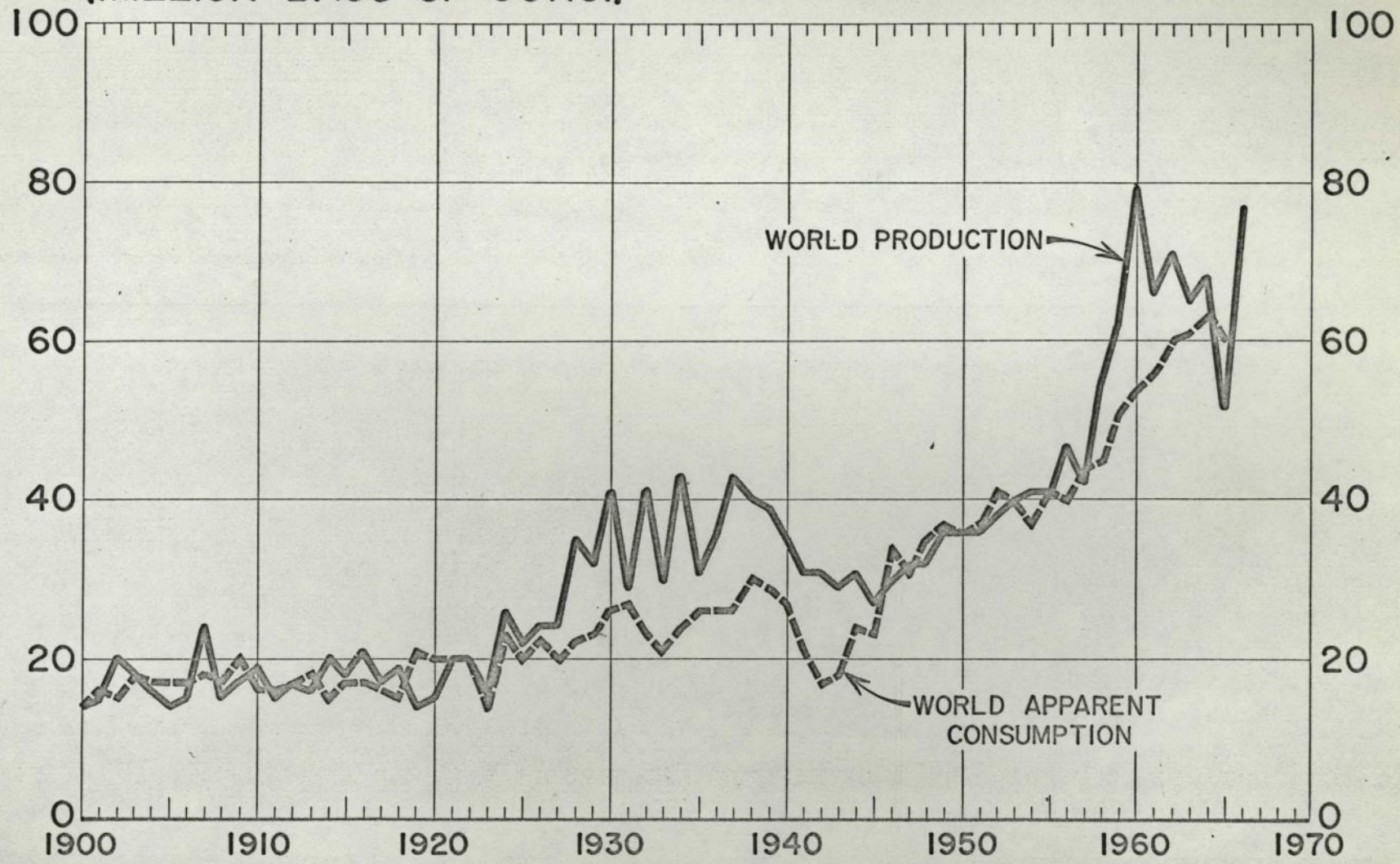
The Coffee Cycle

The beginnings of the present cycle, the fourth in the market history of coffee, 1/ can be placed in the late 1940's, when supply was short and demand was rapidly recovering after the war. The lag in supply and high prices lasted until the mid-1950's. Since then, the world coffee economy has been in the downswing phase of the cycle, marked by large surpluses and the pressure on prices. This phase was interrupted in the last two years by the failure of the Brazilian 1964/65 crop. The interruption proved temporary; the estimated output for 1965/66 is the second largest on record, and the available projections through 1970, admittedly tentative, suggest a continuing high production and a generation of large new surpluses. The end of the downswing phase of the present cycle is unfortunately not yet in sight.

1/ The preceding three coffee cycles have been defined to have taken place in 1870-1910, 1910-1930 and 1930-1950.

COFFEE

(MILLION BAGS OF 60KG.)



NOTE: Prior to 1921 exportable production and net imports.

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The greatest achievement of international cooperation in coffee matters, culminating in the conclusion of the International Coffee Agreement of 1962, has been the prevention of a major collapse of the coffee market, which could have easily occurred at any time since mid-1957. Had it not been for coffee withholding policy of Brazil, Colombia and a few other countries, assisted by some major importing nations, it is likely that we would have witnessed the repetition of the 1930's, with disastrously low prices and major economic and political crises in the producing countries. The experience acquired in operating the International Coffee Agreement so far and better recognition of the gravity and complexity of the coffee problem, will be very much needed in the years ahead if a reasonable degree of stability in the coffee market is to be maintained. But no amount of expert management of day-to-day coffee policy will help unless the root causes of the problem are attacked.

Production Adjustments

It is fairly clear that equilibrium in the world coffee economy cannot be restored unless production growth is arrested for at least half-a-decade or more, to permit consumption to catch up with present output potential and to absorb stocks that will accumulate by 1970. Alternatives are either a continuing accumulation of surpluses or unrestricted competitive selling. Accumulation of surpluses is not only economic and social waste, but it is also questionable how effective it would be in maintaining the foreign exchange earnings. After all, the withholding policy did not prevent the gradual erosion of the price from the 60¢ level in 1956 to 35-40¢ in the last three years; and had it not been for the production failure in 1964/65, the price erosion could have easily gone further. The other alternative - unrestricted competitive selling - would quickly eliminate the surplus problem, but at a very heavy social and economic cost. Coffee-dependent countries would be put through a financial and economic squeeze of unforeseeable consequences. The world coffee economy would receive another major shock: a sharp fall in price, which would most likely result from competitive selling, would lead to a widespread destruction of the capital stock, i.e. premature uprooting of millions of healthy coffee trees, massive enclosures of small coffee farms, wholesale desertion of plantations. And this might easily be followed by another coffee shortage in the early 1970's, with coffee prices again at a dollar a pound and with another wave of investment similar to that of the early 1950's.

1/ The preceding three coffee cycles have been defined to have taken place in 1870-1910, 1910-1930 and 1930-1950.

This leaves, as the only sensible solution, a halt in production expansion. I am not sure whether and how much of an absolute cut-back in production potential, i.e. a planned destruction of a part of the capital stock, would be required: one would have to compare the cost of uprooting the trees now and then planting them back again, say, ten years from now, against net benefits that would be obtained from using the land during these ten years. Until such comparison is made, and on a world-wide basis, one should beware of suggesting destruction. What is beyond reasonable doubt, however, is that any further addition to the world capital stock employed in coffee production would at the present time represent an economic waste.

Such a restrictive policy does not and should not imply that the pattern of production should now be frozen for a series of years. This would be economically harmful: low-cost producers must be allowed to expand and high-cost producers should be assisted to move into alternative occupations. Furthermore, a freeze, even if attempted, most likely would not work: one way or another, new low-cost producers would penetrate the market. Consequently, the twin goals of international coffee policy for the foreseeable future should be to stop any expansion in world coffee production, and at the same time permit, within this limit, some producers to expand and induce some to curtail coffee production.

This proposition is easy to state; to carry it out in practice is most difficult. Who is low-cost producer? Who has alternatives? How well are these alternatives worked out, how expensive to exploit, how profitable? As of this moment, knowledge necessary for a systematic international coffee policy is badly lacking. Thorough analyses are needed of production costs in different producing regions; of elasticities of supply in response to price changes and from different price levels; of alternative investment opportunities and of their employment effects; of their profitability in relation to investment and production of coffee; of the experience with diversification programs attempted thus far. Until such analyses are done, and done in a most objective fashion possible, the international pattern of exports and of production will necessarily have to be based on quotas determined by a historical record (of exports or of exportable production) as adjusted by intuitive judgments, bargaining strength of particular countries at the time of quota negotiations, negotiating ability of the participants, and by accident.

For the more distant future, it is hoped that it will be possible to handle somewhat better the intricacies of the coffee problem. Three international organizations, I.C.O., F.A.O., and the World Bank, have agreed to undertake a Joint Coffee Study which will throw light on some questions of coffee economics. The study will "arrive at new projections of world demand and productions of coffee over the next five and ten years; it will review the conditions of coffee production and indicate and analyze in major producing countries the possibilities and problems of shifting resources from coffee production to economically higher yielding alternatives". The production conditions will be examined in ten producing countries, five in Latin America and five in Africa.

Changing Export Strategies

For formulating an appropriate international coffee policy over the next five to ten years, it will also be necessary to re-examine some of the basic considerations influencing alternative export strategies which major sellers may pursue in the light of changing circumstances. The assumption underlying coffee arrangements thus far has been that Brazil, supported by Colombia, will ultimately hold the price, come what may. Partly as a result of this policy, and partly due to more fundamental factors, the Brazilian share of the world export market has experienced a sustained decline, from 70% before the First World War and 60% in the Inter-War Period to 43% in the 1950's and 37% in the early 1960's. In 1964, the Brazilian share was down to 32% - the lowest point ever reached in the modern coffee history. It is well known that the incentive to hold the price unilaterally - and the benefits from doing so - diminish as the market share declines.

The prolonged decline in the Brazilian share has been accompanied by an equally sustained rise in the African proportion: from 1% in 1909-13 and 5% in 1924-38, to 20% in the 1950's and 27% in the early 1960's. In 1964, at 31%, the African share came for the first time within reach of the unusually depressed Brazilian share. It would be premature to conclude from this, however, that the incentive to hold the price has now become an overriding consideration in the African coffee policy. There is not one but eighteen African sellers, with both common and conflicting interests, and only a few of them are large enough to be able, and have a deep interest in supporting the market. Furthermore, in many of them the most obvious avenue for economic growth in the foreseeable future is further expansion of production for exports, whether of coffee or something else. The only thing which can now be said on the basis of this cursory review is that in the next five to ten years the defence of coffee is likely to become increasingly an international undertaking, even though Brazil (and Colombia) will still have to provide a very large proportion of the overall support.

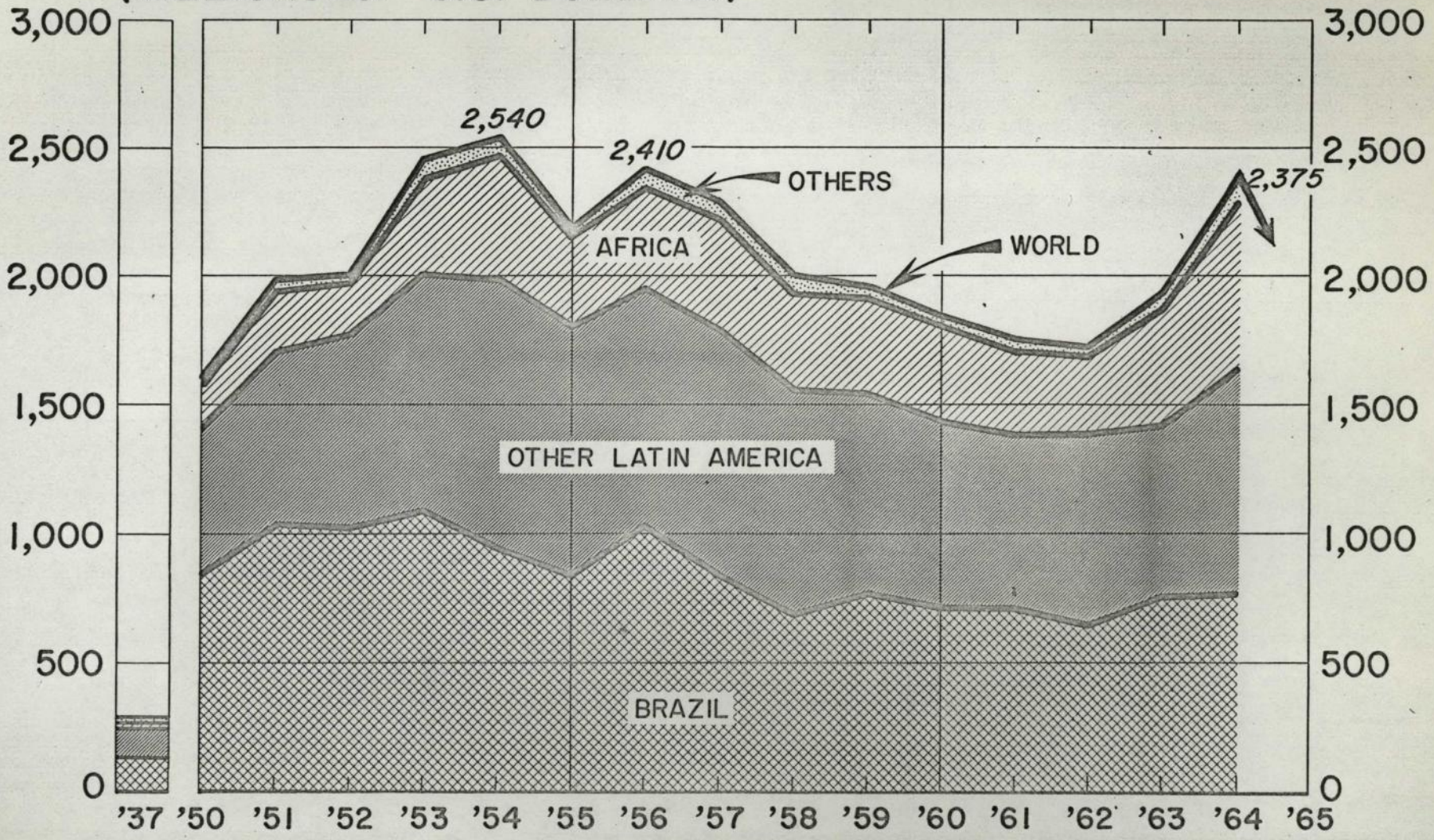
Critical Issue

It has now become almost a platitude to argue that the ultimate solution of the commodity problem lies in diversification of production and export structure. For coffee-dependent countries there is no other way out. They cannot afford the repetition of the disasters of the past; they cannot even afford the repetition of what happened in the last 15 years, even though the record of these years was better than of the earlier coffee history.

CHART II

COFFEE: WORLD EXPORT VALUES

(MILLIONS OF U.S. DOLLARS)



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For eight years, from 1957 to 1962, earnings from production and exports of coffee were falling, year-in-year-out. A major natural catastrophy, destroying almost the whole exportable crop, had to affect Brazil where one-half of world production is still concentrated, for aggregate foreign exchange earnings from coffee to turn upwards in 1963. In 1965, it is certain that coffee earnings will be down again: world imports in the first eight months have been seriously lagging behind the corresponding periods of 1963 and 1964, and the price is weaker this year. The tragic paradox of primary product economies is exemplified by the fact that the coffee countries are now producing for exports a quantity which is almost double the level of the mid-1950's; and yet, their foreign exchange earnings are still below those realized a decade ago. And a great question mark hangs over the future, unless coordinated measures are urgently taken.

The commodity problem does not exist in a product for which world demand rises rapidly and where supply is controlled because the producers are few. The commodity problem is formidable in those products for which world demand, at the present international distribution of income, rises only sluggishly and where the number of producers is large. This is the case with many export products of agricultural origin: there is the uncertainty regarding future international effective demand; output is produced by millions of small farmers scattered all over the globe; it is difficult to execute any long-run investment program; national programs are prepared in isolation from the programs of other nations, and often without knowledge of what other nations are doing or planning to do. In the case of coffee, there are in addition vicious and peculiar chains of demand-price-output-demand reactions that lead to sharp and recurring fluctuations in prices, and to prolonged declines and stagnations of the aggregate value of sales despite rising volume. The capacity of the world coffee economy to satisfy growing international effective demand is not at stake. It is rather the ability to proceed with the expansion in an orderly manner, so that violent disturbances can be avoided; and also, that the long-run comparative advantages of different producers be respected in whatever arrangements are made to insure market stability.

The producing countries will need all the help they can get in working out solutions to these most difficult issues.

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EXTERNAL SOURCES OF FINANCING FOR LATIN AMERICAN GROWTH

By

Dragoslav Avramovic

Paper prepared for the Conference on "The Next Decade of Latin American Development", Cornell University, Ithaca, New York, April 20-April 22, 1966.

EXTERNAL SOURCES OF FINANCING FOR LATIN AMERICAN GROWTH

Table of Contents

EXTERNAL SOURCES OF FINANCING FOR LATIN AMERICAN GROWTH*/

by Dragoslav Avramovic

CHAPTER I. INTRODUCTION

1. This paper does not contain projections of the possible availability of external finance for Latin American development over the next ten years. There is no basis for such projections at the present time. Similarly, the paper refrains from estimating external capital needs of Latin America for the next decade: since at present there are no development programs in the region covering such a time span, there is no basis for systematic estimates of capital needs either. There exist projections of the resource and trade gaps of Latin America, on different assumptions and for different periods: they are based on macro-economic models of differing depth and refinement. Chenery-Strout-Vanek work of the summer of 1965 and the United Nations' staff efforts of 1964 have pushed this line of inquiry to the point where, in my view, very little new can be added.1/ I did not believe that much purpose would be served if I now extrapolated in a hurry another series of numbers: there are probably too many weak and extrapolated numbers around anyway.

2. Instead, an attempt has been made in this paper to put together the past figures and to show what they mean, and then to move on to a discussion of some of the major issues facing Latin America and the donor countries in the near and more distant future. Views will probably differ whether the issues raised are all-inclusive, and also, whether the emphasis is correct. But this is probably inevitable: most writings on Latin America are, for some reason, controversial.

3. My knowledge of Latin American conditions is limited. This paper is based primarily on general notions regarding development, development finance, indebtedness problem and the commodity problem, rather than on specific and detailed information concerning the Latin America scene.

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*/ Paper prepared for the Conference on "The Next Decade of Latin American Development", Cornell University, Ithaca, New York, April 20 - 22, 1966. The author is a member of the staff of the World Bank. The views expressed here are not necessarily those of the Bank. Mr. Eugenio Lari, economist on the Bank's staff, provided valuable help in analytical compiling of the statistical material. Most of the ideas contained in this paper were discussed, and some new added, at a preparatory meeting at Cornell in late January 1966, with Prof. T. Davis and Prof. J. Vanek: I owe them deep gratitude for the most stimulating dialogue and contribution. Mr. Gerald M. Alter, from the Bank, has sacrificed many days to discussions with me concerning Latin America and development problems generally. He, and also Mr. Orvis Schmidt, also from the Bank, were kind enough to read the manuscript, at a short notice, and give me their comments. The responsibility for the paper is entirely mine.

1/ See AID, Summer Research Project, Washington, D.C., 1965, and also, Hollis B. Chenery and Alan Strout, Development Policies and Assistance Requirements, Washington, D.C., 1965 (mimeo); United Nations, Studies in Long-Term Economic Projections for the World Economy, New York, 1964, and also, United Nations, World Economic Survey 1964, N.Y. 1965.

CHAPTER II. THE FACTS

A. World Flow of Development Finance and Latin America: A Conventional View

1. In the five years 1960-1964, the aggregate disbursements of net official assistance (i.e. net of repayments of principal but not net of interest) to developing areas, extended by industrial OECD countries and multilateral agencies, increased gradually from about $4.6 billion to about $6.3 billion per annum. The component flowing to Latin America has risen from $340 million in 1960 to $1.0 billion in 1964, and its percentage share in the total increased from 7% to 16%. In the last two years, however, there has been no change:

Table I

Geographical Distribution of Net Official Flows a/ to Less Developed Countries from DAC Countries and Multilateral Organizations, 1960-1964 b/

(in millions of U. S. dollars)

	1960	1961	1962	1963	1964	Population 1964
Asia	2,237	2,235	2,402	2,758	2,935	933
Africa	1,475	1,657	1,719	1,636	1,722	285
Latin America	335	876	945	1,150	1,018	232
Southern Europe	354	543	468	469	343	91
Oceania	30	10	22	26	20	5
Unallocated	129	256	282	270	219	-
Total, Recipient Countries	4,560	5,577	5,838	6,309	6,257	1,546

a/ Includes loans of one year or more.
b/ Net official flows equal net bilateral official grants and loans received, plus grants and loans received from multilateral organizations, less capital repayments and capital subscription payments to these organizations.

Sources: OECD, The Flow of Financial Resources to Less Developed Countries 1956-1963, Paris 1964; OECD, Development Assistance Efforts and Policies, Paris 1965. Population data are based on current United Nations statistics complemented in some cases by estimates of the OECD Secretariat.

2. In addition to the above flow, developing countries are also receiving private capital funds and loans from the centrally-planned economies, mostly the U.S.S.R. Private capital inflow (including reinvested earnings) has been running, over the last five years, at a level fluctuating between $2.2 and $2.9 billion, without a perceptible trend one way or the other. Disbursements on Soviet credits (and other Eastern European credits) have been increasing, from less than $200 million in 1960 to $425 million in 1963 and perhaps $500 million in 1964. The total flow of external finance to developing countries net of repayments but not net of interest and profits, works out at about $9.2 billion in 1963 and perhaps $9.7 billion in 1964.

Table II

Estimated Total Receipts of Developing Countries 1960-1964 from Bilateral and Multilateral Sources; Net of Repayments; Disbursements
(millions of U.S. dollars)

	1960	1961	1962	1963	1964 a/
(1) Bilateral Official Flow from OECD Members	4,242	5,264	5,388	5,680	5,555
(2) Bilateral Official Flow from Other Industrial Countries	36	49	57	67	n.a.
(3) Bilateral Official Flow from Centrally Planned Economies b/	186	294	391	425	n.a.
(4) Disbursements from Multilateral Agencies, net of Repayments and Subscriptions	283	253	412	654	780
(5) Total Official (1+2+3+4)	4,747	5,860	6,248	6,826	n.a.
(6) Direct Private Investment c/	1,875	1,851	1,437	1,616	(1,630)
(7) Bilateral Portfolio Investment	466	631	234	198	(560)
(8) Guaranteed Trade Credits, above 5 years	93	221	292	248	(390)
(9) Guaranteed Trade Credits, 1-5 years	369	272	253	302	(356)
(10) Total Private (6+7+8+9)	2,803	2,975	2,216	2,364	(2,900)
Grand Total (5+10)	7,550	8.835	8,464	9,190	n.a.

a/ Preliminary.
b/ Gross flow; repayments in 1963 may have amounted to about $50 million.
c/ Including reinvested earnings.

Sources: OECD documents quoted in Table I. Figures in the above table differ somewhat from those in Table I, but the differences can be reconciled.

3. Detailed data on geographical distribution of private capital flows and of Soviet credits are not readily available. However, it is known that Latin America has obtained little Soviet credits (exclusive of Cuba, which is not included in Tables I and II). Latin America receives a fairly large proportion of private capital flows, particularly of reinvested earnings. When a rough allowance is made for the geographic directions of private capital flows and of Soviet aid, and these are added to the known distribution of the official assistance from DAC countries and international agencies (as shown in Table I), it can be said with a reasonable degree of certainty that the share of Latin America in the aggregate world net flow of development finance (i.e. of the $9.2 billion in 1963) is not less than 15% and not more than 20%.

4. The 15-20% proportion comes close to the proportion of Latin American population in total population of aid-recipient countries, which is about 15%. In other words, Latin America now receives "its per capita share" of assistance or even more, after a long period, in the 1940's and 1950's when it received very much less. The African countries are getting much larger amounts than the average per capita share, and so do the countries of Southern Europe (at least they did until two years ago). Less than the average is now obtained by the heavily populated Indian subcontinent, particularly India. Mainland China (not included in Tables I and II) most likely does not receive any assistance at all. The same holds for another heavily populated and poor area: the Indonesian Archipelago.

5. The latest international distribution of development finance - an increase in the Latin American share from earlier inferior level - may be an accidental result of many unrelated lending decisions. It may be just a reflection of some latest twist of international politics. But it may also represent some new emerging pattern of distribution, with its own economic logic. We shall come back to this issue in the concluding chapter.

B. Gross Capital Inflow, Net Capital Inflow and Resource Transfer: Concepts

6. The above description reflects the conventional conceptual framework of capital movements: net capital receipts are equal to gross inflow minus current (income) items. However, an alternative conceptual framework is equally possible and it can be argued that it is at least as meaningful and possibly even more meaningful. If I owe money and service the debt, what is left to me for my own use - for my consumption and investment - is the difference between the sum of my salary plus new borrowing (gross) on the one hand, and the sum of repayments of old debt plus interest payments on debt, on the other hand. Furthermore, if I deal with clever lenders, I don't even know precisely what is repayment and what is interest: they sometime lump the two together. The only thing I know is how much I've got left over: it is only over this residual amount that I have command. The conceptual distinction between capital and current items is all important for lenders: they take for granted that they will be repaid (otherwise they would not lend), and their primary concern is focussed on the rate of interest (return on capital) they will be getting from alternative uses of their funds. This conceptual difference is much less important for debtors, particularly those who are in the market for more borrowed funds in order to augment the aggregate of resources for which they have use: their primary concern is focussed on the difference between new gross borrowing and total debt service (repayments and interest) on the old borrowing, because it is only this difference which serves to augment the funds they can use for investment.

7. We can now move from personal accounts to national accounts. A borrowing developing country obtains at any one time net addition to its resources only to the extent that its gross capital invlow exceeds the total of debt servicing obligations, inclusive of interest, profits and rents, as well as repayments of capital. In balance of payments terminology, such resource transfer is equal to the deficit on merchandise account plus the deficit on transportation, insurance, travel and governmental non-debt transactions. From the viewpoint of real resource availability, this concept of resource transfer is the only relevant one: it is the "true net", as distinct from the "accounting net" used in Section A above.

8. For the developing countries as a whole, the gross receipts of external finance are currently running at about $13 billion per annum. About $4 billion is used for repayments of principal (amortization), leaving the "accounting net" of about $9.2-9.7 billion (see Table II and para. 2 above). The aggregate flow of interest and profits can be roughly estimated at $4-5 billion. This leaves as a resource transfer ("true net") about $5 billion: $9.2-9.7 billion of "accounting net" less $4-5 billion interest and profits. This resource transfer is reflected in the merchandise deficit of developing countries of $1-2 billion per year and in their deficit on non-factor services (transportation, travel, insurance, government non-debt payments) of another $3 billion. The concept of resource transfer serves to explain the puzzle which frequently baffles both the economists and the non-economists: how come that the trade deficit of developing countries is only $1-2 billion[1/] when OECD countries and international organizations make available assistance of 9 billion (6 public and 3 private) and there is also Soviet assistance of $0.5 billion as well. The puzzle is easily explained: one-half of net ("accounting net") capital inflow is used to finance the reverse flow of interest and profits and of the remainder much is used to finance deficit on non-factor services -- transportation, travel and the numerous diplomatic service of developing countries.

9. In a more generalized fashion, the higher the international indebtedness of a particular country or region and the larger the foreign-owned capital stock, the greater the amount of repayments and of interest and profit charges, and correspondingly, the smaller the resource transfer they will obtain per unit of gross capital inflow. This in no way means that it is an incorrect policy to import capital and that countries that have been importing large masses of capital and incurring large debt servicing obligations as a consequence, are worse off than those that have been isolated from international finance. To the extent that productivity and savings have risen as a result of capital imports, and have risen in excess of interest and profits accruing to foreign capital, the recipient country is better off: its present dependence on continuing resource transfers is smaller than that of a country whose productivity has lagged behind, although the former carries substantial foreign obligations while the latter carries none. Colombia and Chile, with large debts and large foreign-owned capital stock are better off, in terms of per capita income, than are Burma and Nepal: the latter have no debts but no development either; their per capita income is one-sixth of that of Colombia and Chile.

10. Large obligations arising from past capital inflow, however, have serious consequences: a very large proportion of current gross capital inflow has to be used to service the debts incurred in the past; and it may happen

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1/ In 1965, the deficit amounted to only $0.5 billion.

that no resource transfer takes place despite large gross or even large "accounting net" capital inflows. What may look as an "equitable" international distribution of finance for development in terms of "accounting net" flows, may in fact be an inadquate distribution in terms of resource transfers.

C. Capital and Real Resource Receipts of Latin America: A Non-Conventional View

11. Latin American international public indebtedness is proportionately much larger than that of other developing regions, and more foreign private capital is invested in Latin America than in any other developing area. At the end of 1964, close to two-fifths of the $33 billion aggregate public indebtedness of developing countries was owed by Latin American countries.1/ In the same year, more than two-thirds of the $14 billion U.S. direct private investment in developing areas was located in Latin America.2/

12. The effect of this deep involvement in international finance - and of much borrowing on short term and at high rates of interest - is a large flow of repayment and interest obligations on public account and a large flow of interest and profits accruing to foreign private capital. A further effect is that large amounts of gross as well as "accounting net" capital inflows are needed to yield meaningful amounts of resource transfers.

1/ World Bank data.
2/ U.S. Department of Commerce, Survey of Current Business, September 1965.

LATIN AMERICA: GROSS CAPITAL INFLOW, NET CAPITAL INFLOW AND RESOURCE GAP

(MILLIONS OF DOLLARS)

IBRD-2979

Table III

Latin America: Capital Flows and Resource Transfers, 1951-1964
(In million of US dollars)

Year	Gross Capital Inflow (1)	Net Capital Inflow ("Accounting Net") (2)	Resource Transfer ("True Net") (3)
1951	1,196	973	460
1952	1,501	1,290	870
1953	475	- 144	-577
1954	816	317	- 76
1955	976	435	1
1956	968	443	- 71
1957	2,025	1,304	837
1958	1,998	1,076	565
1959	1,698	689	109
1960	2,632	1,513	831
1061	2,893	1,676	926
1962	3,068	1,576	721
1963	2,502	966	165
1964	(1,650)	(900)	(6)

NOTES:

(a) No sign indicates capital inflow and resource gap, respectively. Minus sign indicates capital outflow and resource surplus, respectively. The difference between gross capital inflow (column 1) and net capital inflow (column 2) equals repayments of principal and repatriation of foreign private direct investment. The difference between net capital inflow (2) and resource transfer (3) equals earnings of foreign capital, i.e. interest, profits and rents, plus salaries of foreign personnel (the latter is negligible).

(b) The aggregation of regional data inevitably conceals wide country-to-country differences. Venezuela generates a resource surplus which is taken up by profits of oil companies, while the poorest countries in the continent -- Bolivia, Paraguay, Honduras, Guatemala, Ecuador -- have a resource gap which is filled by public capital inflow. (This is also the case with Chile.) If we excluded Venezuela, the continent would show a considerable resource gap; if we excluded the poorest countries, it would show a considerable resource surplus. However, the position of the major countries -- Argentina, Brazil, Colombia, Mexico, Peru, Chile -- would be the same as in the chart: a small resource gap. Country-by-country data are given in the Statistical Appendix.

(c) Data for 1964 are preliminary.

Source: International Monetary Fund, Balance of Payments Yearbooks, various issues.

13. In the last fifteen years, Latin America was drawing resources from the outside world to the tune of $333 million per annum on the average, (Column 3, Resource Transfer, "True Net"). In order to acquire net resources of this magnitude, Latin America was borrowing gross $1.7 billion (Column 1, Gross Capital Inflow) and net $930 million yearly (Column 2, Net Capital Inflow, "Accounting Net").

14. There is no discernible trend in the resource transfer series. There is one disturbing fact, however: after a sharp increase in 1960-1962, the resource transfer dropped sharply in 1963 and completely disappeared in 1964. A similar phenomenon had occurred in 1953-1956, during the Commodity Boom; except that at that time real income was rising rapidly, while in the last few years it increased at a slow rate, with a shortage of resources felt across the continent.

15. It is not known at the present time whether the decline in the resource transfer in the last two years is a temporary phenomenon: this can be verified by comparing the expected disbursements on existing loans with the known schedule of debt servicing obligations plus an allowance for private capital earnings. In any case, it is clear that very large amounts of gross and net capital inflow are now needed to accomplish resource transfer of any serious magnitude.

Table IV

Latin America
Resource Transfers in Relation
to Net and Gross Capital Inflows

A. Absolute Amounts
(in millions of U. S. dollars:
yearly averages)

	Resource Transfer	Net Capital Inflow	Gross Capital Inflow
1951-1955	135	575	1,000
1956-1960	450	1,000	1,850
1961-1964	450	1,280	2,530
1963-1964	85	930	2,075

B. Proportions
(yearly averages)

	Resource Transfer as % of Net Capital Inflow	Resource Transfer as % of Gross Capital Inflow
1951-1955	23	14
1956-1960	45	24
1961-1964	35	17
1963-1964	9	4

Source: Table III.

16. A number of practical complications arise as a result of the present very low ratios of the resource transfer to gross and net capital inflows. Straight project lending for foreign exchange component becomes increasingly difficult: liquidity problems, arising from debt servicing obligations, require that a large proportion of gross foreign capital inflow be on a program basis. It is probably no accident that program lending to Latin American countries has increased in the latter years. This may also reflect changing attitudes in the philosophy of lending techniques. There is no way of knowing which has been the primary factor: I suspect it was the former.

17. A large part of the responsibility for the declining ratio of resource transfers to net and gross capital inflow is due to financial practices of the Latin American Governments. A large part of the debt was contracted on maturity terms and interest rates which some other borrowers would not accept. On the other hand, it is an old truth that it is the lenders that ultimately decide on the terms. It can be argued, with more or less persuasion, that the lack of suitable institutions and policies on the part of lenders have been instrumental in inducing the borrowing countries into excessive contracting of suppliers' credits and of short-term high-interest debt, including debt to compensate for export shortfalls. The arguments and counter-arguments can go on indefinitely.

18. What is important for the future, however, is not so much who is right regarding the past, but what lessons can be drawn. If the discussion is put on this plane, then both sides will probably agree that there was plenty of unnecessary financial mishandling in the borrowing countries, and there was also failure of policy and lack of institutions in the donor countries.

19. Whatever the explanation for the present size of the repayments-cum-interest-cum-profits flow, it is a fact that the resource transfers to Latin America have been small in recent years, however measured; and it is also a fact that gross borrowing has to be now a very high multiple of the resources to be transferred.

20. The unpleasant facts are no less facts for being unpleasant.1/

1/ The Economist, London, sometimes in 1947, discussing, if I recall correctly, the European economic position.

CHAPTER III. THE QUESTIONS

1. In the remainder of this paper the following questions are raised:

(a) Is the resource transfer as established in the preceding chapter the maximum which the Latin American countries can usefully absorb in investment given the supply of complementary factors, such as skills, ability to organize production and natural resources;

(b) If Latin America can absorb, i.e. productively use, a larger amount of resource transfers from abroad than at present, should it get such an increment? What strategy of development assistance would the donor countries have to pursue (or what strategy would be implied) if the resource flow to Latin America is to be increased;

(c) Assuming that answers to the questions under (a) and (b) are affirmative, what efficiency measures are needed to maximize the effectiveness of such enlarged resource inflow.

2. It is probably not possible, on the basis of present knowledge, to answer definitively, and unanimously, the question (a), although it is essentially only a factual question. But hypotheses can be formulated: and when facts and knowledge are missing, the readers are free to choose whether they believe in the hypotheses or not. It is an old truth that the less facts and knowledge are available, the livelier the debate.

3. Question (b) is one of policy: consequently, the answer cannot be obtained from economic analysis. However, the analysis can throw light on the alternatives and on their likely costs and benefits. Question (c) can be answered relatively easily, since it is a technical question.

4. Chapters IV and V discuss the absorptive capacity constraint, other obstacles to growth and the growth objectives which Latin America may conceivably wish to pursue, i.e. question (a). Chapter VI focusses on the strategy of international development assistance, i.e. on question (b). Chapter VII sets forth the efficiency conditions which have to be met if an enlarged resource inflow is to be effectively used, i.e. question (c). The concluding Chapter VIII attempts to pull together the different threads of the argument.

CHAPTER IV. ABSORPTIVE CAPACITY CONSTRAINT AND OTHER OBSTACLES TO GROWTH

A. Absorptive Capacity

1. Can the major Latin American countries absorb more external resources than they are currently obtaining? The answer is probably positive, and for the following reasons:

(a) The major Latin American countries already have available what might be called organizational infrastructure. They have large and modern business units, both national and foreign-owned; and in most of these countries, as the examples of Brazil and Mexico have shown, business has become very adaptable: within a few years, a coffee exporting house can branch out into construction, construction machinery, internal trade and banking. The ability to organize production and to combine the factors of production is there, although not to an equal degree everywhere. The business in Argentina, if it was not hamstrung by factors beyond its control, is probably not much less imaginative and able than the business in Italy or Spain.

(b) There are apparently skills in Latin America, frequently in excess supply for the present level of investment and production. I am referring to critical skills for growth: graduates from engineering schools and intermediate technical manpower. I understand that unemployment, emigration and use of these critically needed people for jobs where their knowledge is not needed, have become a fairly widespread phenomena in the more advanced Latin American countries.

2. If the above hypotheses are correct, then major Latin American countries should be able, by using much greater amounts of net resources from abroad than presently and improving efficiency in resource use, to achieve substantially higher rates of investment and growth.

3. The above conclusion is not invalidated by the argument that the governments in most Latin American countries, which will have to play a critical role in raising the rates of investment in the public sector and in stimulating higher investment in the private sector, are slow, inefficient, politics-ridden, personality-ridden and, on occasion, even corrupt. As the examples of developed countries have shown, this situation can be cured in times of emergency, if the society as a whole has enough skills and organizational talent, if there is determination to mobilize such talent, and if the job for which it is mobilized is such as to inspire enthusiasm and self-sacrifice. The efficiency of governments in the developed countries in peacetime is, as a rule, much inferior to the efficiency of major corporations or of research institutes; while corruption, unfortunately, is not any country's monopoly. Yet, these same governments may become, in times of war, extremely efficient and powerful machines, as ruthless, fast and talented as the best corporations and the best research institute: they are forced by the emergency and by the instinct of self-preservation, to remove those who are slow, mediocre, inefficient and self-centered and to propel instead the brilliance and courage, from within the ranks if available, from outside if necessary. There is no inherent reason why the Latin American governments should behave differently, provided: (a) economic growth is considered top priority task, and (b) there is sufficient talent around, whether within the governments or outsides, to undertake and manage the higher levels of investment and production.

4. We are thus driven back to the hypotheses (a) and (b) in para. 1 above, concerning the availability of skills and organizational talent. But we have also raised the question of whether acceleration of growth will be given top priority by the Latin American governments. This latter question, essentially sociological, will be picked up at the end of this chapter, after we have run through the major technical obstacles to growth other than the absorptive capacity constraint.

B. Other Obstacles

5. These can be listed briefly: lack of suitable investment projects and slowness in their execution; narrowness of the domestic market; frequent industrial recessions; disincentives caused by inflation; disincentives caused by wrong pricing policies depressing the marginal efficiency of capital. But it can perhaps be argued that these obstacles can be overcome, at a cost, once it is made clear that their removal is a prerequisite for the success of a major and firmly planned development effort.

(a) Project Lags

6. There is no doubt that the utilization of funds for already approved projects has been in many cases painfully and unecessarily slow, due to red-tape in recipient countries, Latin America included. There is also no doubt that a much larger flow of projects offered for financing is needed if a substantial increase in investment is to materialize. On the other hand, the question can be raised whether the present procedures in some lending agencies are capable of handling such larger flow of projects if it were to materialize. They have their own red tape; and their project preferences are sometimes or even frequently inconsistent with the priorities of the recipient country: the latter favors assistance to agriculture and industry, while some lending agencies are fond of roads, and more roads.

(b) Small Markets

7. The disincentives and inefficiencies caused by the narrowness of the national markets in Latin America can be cured only if there is a systematic and accelerated movement towards regional integration. The issue is important even for Brazil although it has a large internal market, and even for Mexico, although it is placed close to the huge U.S. market; it is crucial for all other Latin American countries. Integration movement has been painfully slow thus far: there are examples of red-tape and political conflicts even in an infra-structure sector where no serious vested interests are involved.

8. Whether the Latin American governments can persuade each other to subordinate individual interests to a collective interest is a matter of political judgment; but economics will have to do much with the outcome. Integration of Latin America will be easier to achieve and the incentive to invest greater, if the whole continent, or most of it, aims at and achieves a rate of growth substantially above the recent past. When new capital accumulation proceeds at a rapid pace everywhere, it is easier to allocate investment in particular sectors according to sensible regional schemes: investment in one country is not at the expense of investment in another country, but both supplement each other and at a high rate of investment. This I believe was the original idea of Prof. Rosenstein-Rodan in his celebrated article of 1943.1/

1/ P.N.Rosenstein-Rodan, Problems of Industrialization of Eastern and South-Eastern Europe, The Economic Journal, London, June-September 1943.

(c) Recessions

9. Industrial recessions of Latin America - the sad recurring phenomena of underutilized capacity in the face of very strong competing claims on resources - have their root cause in imbalances in supply of particular goods and particularly of foreign exchange, which cause the whole machine to halt and which squeeze out the profit margins despite continuing expansion of money supply. These are the phenomena of "inflationary recessions" of Mr. Macrae, 1/ the sequence of events in which, according to Prof. Olivera, Latin America constantly moves from "unbalanced growth" to "unbalanced stagnation" and back again.2/ These interruptions of the growth process cannot be eliminated or even moderated unless the flexibility of the economies increases; the latter cannot be increased unless the rate of growth is accelerated; this cannot be done unless the rate of investment is higher; and it cannot be higher unless more resources to finance such higher investment are available.

(d) Inflation

10. So much has already been written about the Latin American inflation, that nothing conceivably new can be found to add, however hard one may try. One fact can be put forward, however:

Table V
Value of Imports per Capita, 1948-1963
(in U.S. dollars)

Year	Total Developing Regions	Middle East	Asia (excl. Japan)	Africa (excl. S. Africa)	Latin America
1948	18.7	23.5	10.8	19.4	44.8
1949	19.1	27.1	12.0	20.3	40.3
1950	16.8	24.2	10.1	17.3	37.8
1951	23.3	28.4	14.5	23.1	53.1
1952	23.1	28.6	14.0	25.0	51.7
1953	20.1	27.5	11.9	22.0	43.7
1954	20.6	29.2	11.0	22.4	48.7
1955	21.8	33.9	12.1	24.0	48.1
1956	23.1	37.0	13.4	24.5	49.5
1957	25.6	39.8	14.9	26.5	55.7
1958	23.3	40.5	12.7	25.5	49.9
1959	22.6	42.5	12.8	24.4	46.0
1960	24.4	45.6	14.6	26.0	47.2
1961	24.5	47.1	14.5	25.9	47.6
1962	24.1	46.0	14.8	23.9	46.6
1963	23.1	44.1	14.5	23.6	42.5

Source: IMF, International Financial Statistics and U.N. Demographic Yearbook, various issues.

1/ Norman Macrae, The Economist, London, September 25, 1965.
2/ As quoted by Macrae. See also, Inflation and Growth in Latin America, Rio Conference of 1963, published by the Economic Growth Center, Yale, Irwins, 1964.

11. "In Middle Eastern countries, imports per capita have almost doubled. This region accounts only for a small share of the population living in less developed countries. Asian per capita imports have risen appreciably; the increment was financed by foreign assistance. Imports into Africa per head have risen only moderately, and those into Latin America have been at a standstill."1/

12. And an interpretation: "As a rule, total income cannot be expected to rise rapidly over the long run if there is a severe restraint on the volume of imports that can be financed. There have been cases in economic history where fast growth in output has occurred in the face of unchanged imports; some of these cases have occurred since the war" /Brazil/. "But such instances of net import substitution have not been numerous and they have taken place only over limited periods of time".2/ /Soviet Union in the 1930's, Australia in late 19th century/.

13. "The capacity to import influences the rate of purchase of that capital equipment which is indispensable for accelerated growth and for the diversification of production and export structures. Unless export earnings grow at a sufficiently fast rate or unless they are supplemented by net inflow of foreign loans and grants /this should have read net resource inflow/, the processes of capital accumulation and diversification may tend to slow down. Alternatively, the burden of adjustment may be shifted to personal and government consumption; and alternatively still, the pressure of competing claims of investment and of consumption in the face of stagnating imports may lead to inflation which will then tend to aggravate the balance of payments."3/

14. Stripped of the verbiage, this says that any country whose supply of imported goods per capita has stagnated or even declined over the 15-year period, would be in a considerable difficulty, just as any individual or a family whose purchases have not risen over 15 years would feel bad, particularly if at the same time the standard of living of its neighbors had shown a constant climb. It further says that in a situation in which an unchanged level of import capacity has to accommodate more purchases of capital goods, more state welfare expenditure for the poor, more demand for personal consumption of both the middle class and the low class, more extravagant consumption of government officials, more public works to win elections - something has to give. This something has been the printing press: the easy way out for a year or two, and at an advanced inflationary stage, for a week or two.

1/ IBRD, Economic Department, The Commodity Problem, mimeo. 1964 (to be published), p. 9.
2/ Ibid., p.9. See also, Johan Froland, Demand for Imports in the Process of Growth and Structural Change, published in IBRD, Economic Growth and External Debt, The Johns Hopkins Press, 1965.
3/ Commodity Problem, op. cit., p. 9.

15. I believe there are theoretical flaws in Macrae's recent most interesting analysis of the Latin American inflation and of its environment.1/ As I understood it, the argument is almost Keynesian: the Latin American economies have large unemployment, and they also have spare capacity; consequently, an expansion of effective demand would raise domestic output and employment; and the only factor which prevents this policy is the acute shortage of foreign exchange, i.e. the absence of any cushion which would absorb leakages into imports, presumably quite moderate, of the expanded monetary demand. I have doubts whether the surplus capacity is that significant; consequently, I doubt that the expansion of monetary demand would, per se, lead to higher domestic production levels and employment; and I should think, based on past experience, that much of the incremental demand would leak into imports, inducing frequently a massive conversion of domestic money assets into foreign currency, i.e. the flight of capital as well. (The latter may ensue even if - or because of - the exchange rate is let to fluctuate in order to keep the demand for imports within bounds).

16. Macrae's policy prescription seems to be that it is sufficient to provide Latin America with a foreign exchange cushion so it can expand effective demand and reach full employment; and then, it would seem, it is sufficient to change the rules of the world trading and monetary systems so that Latin America is enabled to replenish periodically its exchange reserves so it can continue expanding employment. I would argue that Latin America needs urgently more resources for investment in order to increase substantially its capital stock; it can then employ productively many more people and also, supply such rapidly growing employed labor with much more capital per head, so that it can become a modern diversified industrial system able to compete in the world market not only in coffee, cocoa, bananas and cotton, but also in the production of shoes, plastics and automobiles. In order to carry out this formidable task of structural transformation with tolerable smoothness, Latin America (and other developing countries) need a change in the rules of the game, especially insofar as commodity markets are concerned: but this will not suffice. Only as the production potential is greatly expanded through much larger investment than currently takes place, will it be possible to bring under control the ultimate origin of contemporary Latin American inflation: the incapacity of the political system to allocate in an orderly fashion resources among growing claims of competing social groups, because the aggregate of resources is small and only slowly increasing.

17. Whichever of the two theses is correct, more resources are needed: in Macrae's thesis perhaps a smaller amount but exclusively from outside; in mine, probably larger resources, but both from outside and from inside for purposes of investment. In terms of need for more foreign assistance, the difference may not be large at all: Mr. Macrae would call it change in the rules of the game, and I would call it much larger resource transfer, smoothed out, as necessary, by the change in the rules.

1/ Macrae, op.cit. His analysis carries the title "No Christ on The Andes, An Economic Survey of Latin America by The Economist".

(e) "Foreign Exchange Lottery"

18. Irrespective of the above argument, it is difficult to disagree with another major thesis of Macrae: his theory of foreign exchange lottery. Latin American countries, as well as other developing countries, badly need foreign exchange qua foreign exchange: without a satisfactory supply of it, whether acquired from loan proceeds or from own exports, it is impossible to run the productive machine of any relatively small country in view of its dependence on imported supplies. Most of foreign exchange is generated by country's own exports; and it is now a matter of natural resource accident whether a country happens to be lucky and produce petroleum and gas or unlucky and produce jute, coffee or tea. In the first case, as a winner in the foreign exchange lottery, it does not have the trade problem (although it may still have a very serious budgetary or skills problem); in the second, as a loser in the lottery, the country is stuck with the severe foreign exchange constraint which will hamper its growth even if it has solved its budgetary (resource) problem and has much of the skills it needs for growth.

"The principal bottleneck in the way of development in Latin America is a bottleneck in foreign exchange...Most Europeans do not begin to realize how desperately Latin America is still suffering, nearly forty years after the even, from the world slump of the late 1920's. Between 1928 and 1932, Latin America's exports dropped by nearly 60 percent and they have never recovered on a per capita basis since that time". (Macrae's italics).1/

"Nothing is said here that will deny that there are other and internal prerequisites to sound development as well: good government, and adequate managerial cadre, good training facilities for skilled labor, sensible agricultural policy and the rest. But we are found to argue that even if a country in the poor two-thirds of the world progresses towards achieving these in adequate measure, it will not at present necessarily secure sound development unless it is lucky in the lottery that determines whether it has access to a sufficient supply of foreign exchange. The conclusion is that those lottery rules need to be abandoned. They need to be replaced by rules based on sound economic science:...the rule of 'where development is most possible shall development funds be ploughed in'. And Latin America, as the most development-ripe sector of the poor South of the world, is the area where this need has become most blazingly apparent."

"Our thesis is that it is not something vague about Latin American in his culture which at present prevents him from becoming a truly modern man. It is some hard and specific things about the world monetary and trading systems in their present form which prevent countries like those of Latin America advancing as quickly as they could and should to join the ranks of the affluent; and will agonizingly continue to prevent them until the average intelligent observer in the rich northwest of the world wakes up to the opportunities and human responsibilities and mortal dangers of the present stage at which the economic history of our planet has arrived."2/

1/ Ibid., p. X

2/ Ibid., p. XI

19. As a proof of his thesis that it is the constraint on the capacity to import which causes most of the Latin American troubles, including inflation, Macrae quotes the striking difference in the recent economic history and behavior pattern of Mexico, on the one hand, and of Brazil and Argentina, on the other. Mexico did not suffer from inflation or irresponsibility of policy, while Argentina and Brazil did. If there is something special in the Latin American mentality which makes them particularly susceptible to inflationary temptations, it should have happened as much in Mexico as it did in Brazil and Argentina. Or is it argued that Mexico is not a Latin American country? Since this cannot be argued, and since the institutional framework is roughly the same, we are driven to the Macrae's thesis of foreign exchange lottery.

20. Now, it is possible to argue - and some do argue - that the difference in the behavior pattern of Mexico compared to Argentina and Brazil is due to the fact that Mexico has already carried out its political and social revolution while Argentina and Brazil have not. I do not know how historically accurate this argument is. But even if it is, the nagging question still remains: Peru experienced a great export boom in the 1950's and early 1960's, based on metals and fishmeal, and it had very responsible monetary and foreign exchange policies. Was this also due to the fact that it has already carried out its political and social revolution? Or because the Peruvian politicians are by nature more responsible than the Brazilian or the Argentinian ones, they saw the advantages of sound policies and applied them ruthlessly? Or perhaps the key was to be found in the hard facts of copper and fishmeal, and on the additional fact that the Indian population in the High Andes is still more docile than the Brazilian and Argentinian urban and rural workers, so that there was a sizeable flow of foreign exchange (9% per annum growth) on the one hand, and not much pressure for public social welfare expenditure, on the other?

21. The answers to the questions raised in para. 20 cannot be provided by economic analysis. Perhaps they can be given by political theory and sociology. For the time being, pending proof to the contrary, it would seem that Macrae is right: and he is in good company. The view that the foreign exchange constraint to growth is a most severe constraint was first developed, in its contemporary formulation, by Dr. Raul Prebisch, in his numerous writings on Latin America and on developing countries generally. Dr. Prebisch's theory of forces that determine the growth process of "the countries on the periphery of the world economy" and his analysis of stagnation and of unbalanced development caused by insufficiency of import capacity and of its fluctuations under the impact of vicissitudes of world commodity markets - were embraced by the U.N. Economic Commission for Latin America and by the United Nations generally; they served as a basis of the United Nations Conference on Trade and Development in 1964; and they have culminated in the recent establishment of the permanent organization of the Conference, marking the vindication of the theory. The theory was further elaborated by Dr. Dudley Seers and many other scholars associated with the United Nations studies; and the authors of its latest formulation are Prof. Chenery, Vanek and Strout, while working for AID. Each of these writers would probably express his views differently than Macrae. But there are certain fundamental points, which are difficult to challenge:

(a) The foreign exchange constraint on growth exists and can be very serious; its origin is in the commodity markets which determine the supply of exchange, on the one hand, and in the growth process which determines the demand for exchange, on the other; the two moving at rates which are not necessarily identical;

(b) The commodity problem does not exist in a product for which demand rises rapidly and where supply is controlled because the producers are few. There are no demand problems in petroleum, nor is there a foreign exchange problem in the major oil-producing countries which can be attributed to export difficulties: the demand increases rapidly, and prices do not fluctuate much over the short run. Similar situation prevails in several metals and minerals (e.g., aluminum, iron ore, copper now) and few other products;

(c) The commodity problem is formidable in those products for which world demand, at the present international distribution of income, rises only sluggishly, so that exchange earnings also rise only sluggishly, below the rate at which demand for imports, associated with a fast overall income growth, tends to rise; where the number of producers is very large and does not diminish because alternative employment opportunities are limited, so that the production is not subject to any coordination and there is a recurring tendency to produce more than the market can absorb at unchanged prices; and where there are peculiar chains of demand-price-output-demand reactions, similar in the chart to the spider's web, which lead to sharp and recurring fluctuations in aggregate values of sales and therefore of foreign exchange earnings, and which also impair the competitive position of primary materials vis-a-vis the synthetics which are stable in prices and sometimes even cheaper on the average. This is the case with most products of agricultural origin; and this is the sector from which most of the population of developing world, including Latin America, derives its livelihood.1/

22. In all lotteries there are more losers than winners: this is the fundamental principle of gambling. Otherwise the casinos would go bankrupt: some do, most do not.

(f) Absorptive Capacity Constraint and Other Obstacles to Growth - Concluded

23. If it is argued that Latin America is incompetent to use additional resources, then the rest of this paper should not be read. Whether it is or not is a matter of facts and of their interpretation. The issue has to be decided by those who know the facts, and it revolves around three points:

(a) Does Latin America have people with sufficient imagination to develop grand designs of public works and of industrial and agricultural development, spanning a decade and more;

(b) Does it have enough organizational, engineering, managerial and administrative talent to mount a much larger investment effort than at present; and

(c) Is it politically capable of committing itself to subordinate all other issues to the issue of growth?

24. Probably few will doubt the (a). There will be doubts on the (b). The strongest doubts will concern (c), if I can judge correctly the feelings in the donor countries. The burden of proof rests with Latin America, since it is they who are asking for money. Notwithstanding all the changes in the world, the fundamental rule of banking remains unchallenged and unchanged: it is the prospective borrowers who have to show what they need money for.

1/ Commodity Problem, op. cit. pp. 35 and 42.

CHAPTER V. WHAT RATE OF GROWTH?

1. In a recent review of national plans of a number of Latin American countries as appraised by aid-giving agencies, I was struck by the fact that a number of them were anticipating a complete closing of their resource gaps in the very near future, i.e., in effect a restoration of the balance of payments equilibrium. Further, everybody will fight inflation. Finally, most plans postulate target rates of growth centered around 5% p.a. This happens to correspond to the goal of the United Nations Development Decade, and it seems quite a respectable target.

2. These three objectives - eliminate the resource gap, achieve a 5% growth rate and get rid of inflation - would commend themselves to most lenders, except the very cautious ones. The latter would raise one question, bearing on a possible fourth objective of the national plans: what employment situation is one likely to have with the three objectives listed above?

> ".. Latin America has the highest rate of population growth in the world. It had 200 million inhabitants in 1960, and in fifteen years it will have 360 million. /It now has an estimated 235 million./ In ten years there will be 38 million more persons in the work force, but at the present rate of employment growth, only /a limited number of jobs will be created/".1/

> "...The dynamic insufficiency of the system to absorb at satisfactory productivity the available labor force is an extremely serious fact to which I have been calling attention insistently in the last few years - a real dialogue with the deaf."2/

3. Now, a cuatious banker will not lend to a country which faces an aggravation of its already quite serious unemployment situation. Unemployment is the worst of all ills that can affect an individual, a family or a country: not only does it lead to starvation, but also to despair and violence in which contractural obligations tend to be forgotten. Alternatively, if an attempt is made, in a developing country, to combat unemployment by expanding government spending, there is inflation which interferes both with the growth process and, through its effects on the balance of payments, with the smooth payment of debts.

4. Target rates of growth of 5% or so are not much higher than what Latin America has already achieved in the postwar period. Since their present national plans assume higher productivity improvements and higher efficiency of investment than in the past, the implication is that employment will increase even less fast than in the past: and the past rate of absorption of manpower was already insufficient to prevent large increases in urban unemployment. It logically follows that the triple objective - 5% growth rate, elimination of resource gap and elimination of inflation - should lead into an aggravation of the social problem, with growing risk of social and political violence. One should be reluctant to lend if this is the risk one faces.

1/ Walter Lippmann, A Look at South America, syndicated column published on December 14, 1965.

2/ Dr. Raul Prebisch, in a private letter of May 25, 1966.

5. There must be a way out of this dilemma. Since inflation has proven not to be very effective in curing unemployment, more inflation can not be the way out: consequently, there is nothing wrong with the anti-inflationary objectives of the Latin American plans. But there may be something wrong with the 5% growth objective and with the consequent objective of closing the resource gap, in the near future.

6. This can be restated in more technical terms. Recently, we have experimented with two contrasting growth models: one assumes, conventionally, a constant target growth rate, while the other does not set any predetermined growth objective and lets the economy grow as fast as it is capable of growing. I have called the latter model "Absorptive Capacity Growth Model". The basic differences between this latter model and the more conventional models are:

(a) Sectoral projections have been substituted for an aggregate projections;

(b) No rate of growth in aggregate output has been assumed either as a target or as a ceiling; growth in aggregate output results from "spontaneous" growth of particular sectors and from the consequential changing sectoral composition of aggregate output.

(c) As a result of (a) and (b), annual rates of growth in aggregate output are variable. Since rapidly growing sectors gain in weight, the rate of growth in aggregate output accelerates over a certain ti e span, in the absorptive capacity model.1/

7. No only does the rate of growth accelerate over time and is on the average higher in the absorptive capacity model than in the target growth rate model, but it turns out that this is a cheaper way to develop. The attached charts indicate that in the long run a ceiling on the growth rate might turn out to be a more expensive path: borrowing and debt will reach higher levels. The reason is that at a constant rate of growth in income, the marginal rate of savings, while higher than the average, will also tend to be constant; while if the rate of income growth is allowed to accelerate as in the absorptive capacity model, it is logical to suppose that marginal savings rate will also tend to shift upwards. Similarly, capital-output ratio declines (productivity of capital increases) in the absorptive capacity model, while it remains unchanged in the fixed target growth rate model: if all investment opportunities are not exploited, shortages and bottlenecks will develop, tending to depress the over-all return on capital. The corrolary is that self-sustained growth growth will be reached faster if all the investment opportunities are exhausted as they arise. Just as it is wrong, from an economic point of view, to set a ceiling on the growth of an efficient firm, it is wrong to set a ceiling on the growth rate of an economy which can achieve more, and without a substantial decrease in returns on capital, if more investible funds are available.

8. "Conversely, if investment opportunities are limited within a given period, it will be both costly and inefficient to push to an unrealistic over-all growth target. It would be better to concentrate initially on widening absorptive capacity, through accelerated and systematic project and program development. Once this is done, investment can be effectively undertaken, and on a rising scale."2/

1/ Nigeria: Debt Servicing Burden and Terms of Borrowing, A Study in Method, IBRD, 1966 (mimeo). Miss Fe Villafuerte, from the IBRD staff, originated the idea of the absorptive capacity model and ran through all the computations.

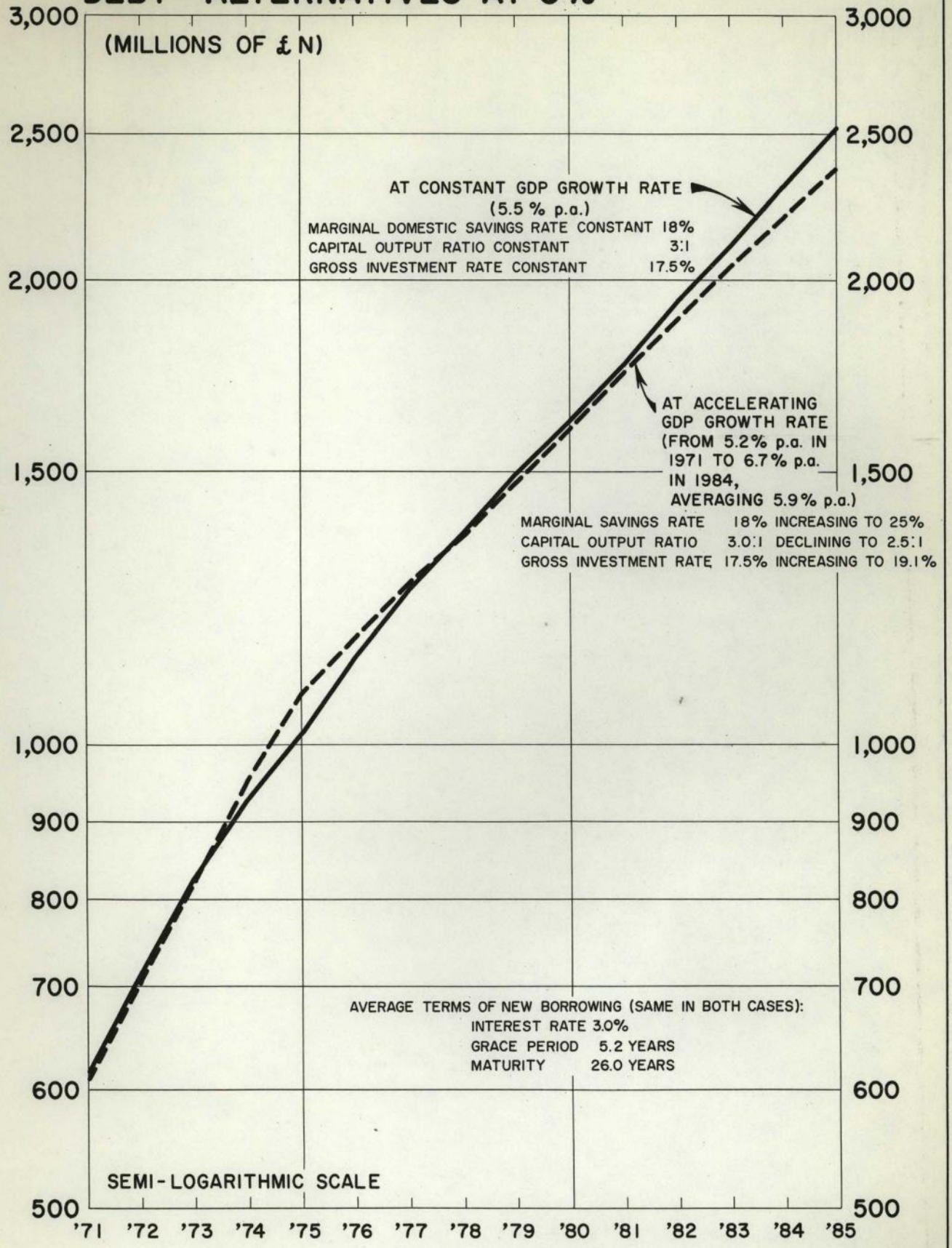
2/ Ibid., p. 55

9. Target rates of investment in Latin America seem to have been set at a level which can not assure that rate of output growth which the economies may be capable of sustaining. This has been done most likely in order to eliminate the resource gap as soon as possible, i.e. in order to assure growth on the basis only of domestically generated resources, in line with much of past experience. The consequence will be rising unemployment, with rising threats to social and political stability - again in line with past experience. Further consequences will be postponement of self-sustained growth and ultimately higher cost of development to the donor countries. Whether this sad sequence of events can be avoided depends on two factors:

(a) Can major Latin American countries undertake more productive investment than at present - the basic hypothesis of the preceding chapter; and

(b) If they can, will more resources be made available - the problem which is examined in the next chapter.

OUTSTANDING PUBLIC DEBT - ALTERNATIVES AT 3%



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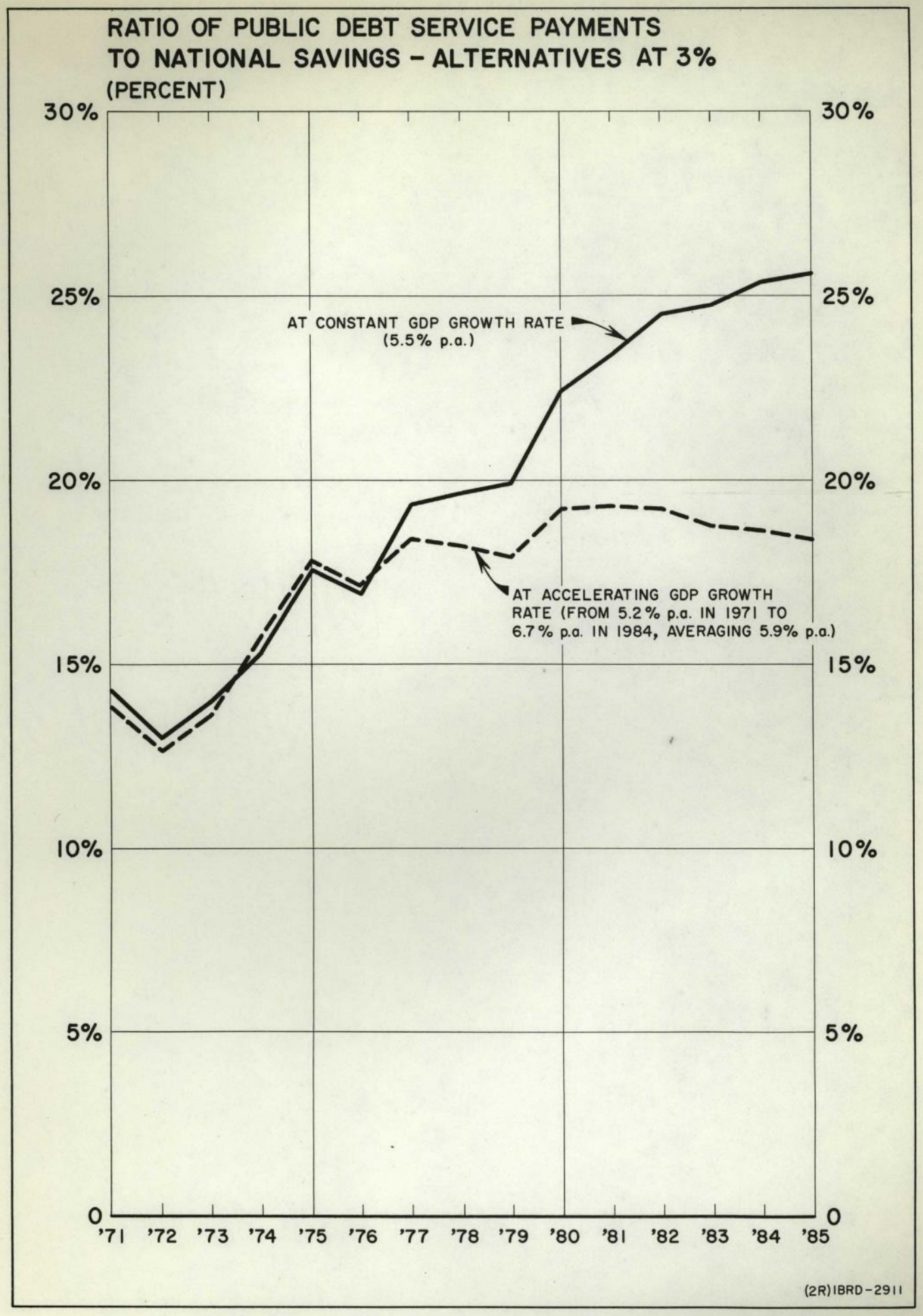

RATIO OF PUBLIC DEBT SERVICE PAYMENTS
TO NATIONAL SAVINGS - ALTERNATIVES AT 3%
(PERCENT)
30%
25%
20%
15%
10%
5%
0
AT CONSTANT GDP GROWTH RATE
(5.5% p.a.)
AT ACCELERATING GDP GROWTH
RATE (FROM 5.2% p.a. IN 1971 TO
6.7% p.a. IN 1984, AVERAGING 5.9% p.a.)
'71 '72 '73 '74 '75 '76 '77 '78 '79 '80 '81 '82 '83 '84 '85
(2R)IBRD-2911

CHAPTER VI. WHAT STRATEGY OF INTERNATIONAL DEVELOPMENT ASSISTANCE?

1. The basic elements of any strategy - whether military, political, economic or market strategy - are, first, clear definition of the objective and secondly, the advance determination of approximate timing of particular major moves in pursuing this objective. When we use these two criteria, then it is probably fair to say that at present we do not yet have a strategy of international development assistance. Is its purpose to raise income levels everywhere, by a certain percentage or by a certain absolute amount and within what period of years? Or is the strategy to select a certain group of "winners" and to concentrate all resources there? Who are the selected ones? And to achieve what? In what time span?

2. The same questions have been raised in a recent document prepared by the OECD/DAC Secretariat:

> "Should a gap calculation be based on a uniform rate of growth for all developing countries? Such a uniform growth target might appear equitable, in the sense of treating all developing countries alike. On the other hand, a uniform per capita growth target would aim at maintaining the existing proportionate differential between the poorest countries and those which are somewhat less poor, and this might be considered inequitable. Similarly, a uniform growth target for total income might appear inequitable in "penalising" the countries with high rates of growth of population."
>
> .....
>
> "The main argument against a uniform growth target is that it leaves out of account all considerations of the relative efficiency with which different countries convert external assistance into economic growth. A uniform target rate of growth for all countries would demand more assistance per capita for the less developed countries than for the more developable. In this sense, it "rewards" inefficiently, poor resource endowment, adverse geographical locations, and all the influence which make economic development costly in external assistance, and "penalizes" efficiency, etc." 1/

3. Concentration of assistance on selected countries, however they may be selected, carries the risk of great failure if the selection turns out to be wrong. Dispersal of assistance all over the place means that resources are spread wide and thin and therefore are ineffective. We are between the devil and the deep blue sea - and we have been there since the very beginning of the international development effort.

4. There is of course, a way out. The second choice - strategy of dispersal - is certain to fail: the latest fairly widespread dissatisfaction with foreign aid and its results is a serious warning. The first choice - strategy of concentration of resources - is full of risks, but it carries a promise that at least in some countries the growth process will succeed, and in the foreseeable future.

1/ OECD/DAC: "Gap" Estimates - Calculation and Significance, Paris, (1964 (mimeo.). Much of this chapter is based on discussions protracted over years, with the author of the OECD/DAC study, Mr. J. P. Hayes.

5. The trouble is that the above argument is unrealistic. As long as the aggregate level of assistance remains what it is now, it is very doubtful that much can be changed in its present distribution. Who would be prepared in a couple of years to cut down in half, say, the allocation to Africa in order to increase the Latin American flow, or cut down in half the Latin American allocation in favor of Asia? The risks of disturbance and dislocation are too severe for anybody to contemplate such actions seriously. The change in the allocation can occur only on an incremental basis: if it is decided to raise the level of assistance by, say $5 billion, this increment can be distributed differently than the present level of development finance without risks other than displeasure of those whose proportionate share would fall (although their absolute amount would remain unchanged or may even increase somewhat).

6. The critical question thus becomes what are the chances - and ways - of getting more assistance funds from the donor countries. Everybody will now agree in principle after UNCTAD, that the volume of assistance will have to increase. Yet, no concrete plans are under way, and there are great misgivings in the developed countries regarding the effectiveness of the assistance effort. Furthermore, the developed countries themselves are embarking, for the first time in a systematic fashion, upon the task of eradicating poverty in their own societies. Consequently, the less developed countries compete not not only among themselves for assistance; they are also competing for resources with the underprivileged in the developed countries themselves. Lack of strategy in international development assistance, the feeling that past efforts have been ineffective, and the rising conscience that assistance is needed for the poor also in the developed countries, are the fundamental causes of stagnation of the flow of assistance in the recent past.

7. It can, of course, be argued that both external assistance and domestic assistance can be increased simultaneously: the industrial systems of the West can produce much more if necessary, for example under conditions of war or active preparation for war. It can also be argued, as it has in fact been argued, that the task of development of the poor countries is analogous, or should be made analogous, to war, for all concerned: "Development, to be successful, requires a dedication and singleness of purpose. However, thus far, no means have been devised to deeply stir patriotic emotions for massive and intensive economic development in agriculture or in extractive and manufacturing and service industry. Yet, development should be waged as a war -- a war against intolerable living conditions that must be carried on with a determination to overcome all obstacles."2/

8. While it is true that economic development, unfortunately, cannot generate as much enthusiasm as wars can, or at least did not thus far, there was a period, after the Second World War, when a similar job - European reconstruction - did stir emotions. Whoever had participated in the Marshall Plan recalls with nostalgia those days of enthusiasm and fervor. Why is the situation different with the development assistance to the poor areas? Because there are fundamental doubts whether they can ever develop? Or because the time-span of assistance needs seems indefinite or even infinite?

9. There is no point in denying that doubts do exist. After all, if the problem of development was easy, it would have been solved long time ago. There must be something badly wrong in the societies and in the systems which have held the per capita incomes at $50 for centuries; and until we know what that "something" is we shall not make much headway. And since we do not know what has caused poverty-cum-stagnation, how can we be sure that the poor countries will ever become rich?

2/ George D. Woods, Address to the Board of Governors, World Bank, International Finance Corporation and International Development Association, September 27, 1965.

10. But again, not all 80 developing countries are equally poor and stagnating: there is quite a number which have moved up considerably up the income scale. It is logical to suppose that the fundamental obstacles to growth, whatever they may be, are less severe in countries at $400 level of per capita income than in those at $50. It is also logical to argue that if a country has moved from $50 to $400 per head and only then got stuck, it had, in fact, overcome the worst of the obstacles: lack of education, lack of organization, institutional constraints on mobility of social classes; and it had then got stuck for some specific reason or reasons which, once removed, would permit the country to resume the upward growth trend, and at an accelerated rate since it should now be able to incorporate the technological progress, in lump doses and free of charge. In other words, the growth problem of Argentina should be more easy to solve than the growth problem of Nepal. Argentina was no different than most of Europe in 1914, it was ahead of Italy and some Central European countries. The latter moved forward, in the late 1940's, 1950's and early 1960's, at a very rapid pace; their stagnation lasted only a fifth of a century, from 1914 through 1946. Argentina's stagnation has now lasted half a century, and the country has been left behind. But the fundamental problem of growth should be no more difficult in Argentina (or Uruguay) than in Italy; if anything it should be easier, because the resource base is more favorable. And since Mexico has shown that there is nothing wrong with the Latin American mentality in so far as growth propensity is concerned, the problem of Argentina should not be impossible to resolve, just as the problem of growth in Spain is now being resolved, after 30-40 years of stagnation.

11. We can use another example: Brazil. As a result of postwar development, one-third of Brazil - the triangle Rio-Sao Paolo-Belo Horizonte - has emerged as industrial and trading heart of a country that is half a continent. A country that has succeeded in developing its own machine tool, steel, chemicals and automobile industries within a decade or so, should be able to push through the development of the North-East: the latter problem is severe, but less so than the problem which has already been solved, that of lifting the country as a whole from being exclusively an exporter of primary materials to a diversified and major producer of most industrial products. Why should the growth rate of Brazil be postulated at 5%? Why it should not be 7% or even 10%? At 5%, no resource transfers will be needed, just the funds to service the existing foreign obligations, and this will be cheaper over the short run. But at a 5% growth rate unemployment will increase and social tensions will aggravate. Even more important, Brazil will remain a poor country much longer than necessary; and the cost of development will be much greater over the long run.

12. The same holds true for all countries that are at $300-400 per capita income, be they in Latin America or in Southern Europe or elsewhere. They have most of the skills and organizational tradition necessary for rapid growth. But most do not have firm plans of investment and firm policies for growth; and they do not have finance.

13. There is no inherent reason why such countries should not be able, with external technical assistance as needed, work out detailed long-term investment plans, with clear overall and detailed sectoral objectives; and in the case of these countries, these objectives can lead to a major new step in development over a period of, say, 10-15 years. Such long-term plans should aim at creating a modern industrial society. The plans will have to be based on specific targets of investment in particular sectors, on firm major projects, on plausible projections of employment and other input requirements. Such plans would have to be accompanied by a firm commitment of best efforts of the country to contribute a certain percentage of its resources to its own development.

14. I believe that a major increase in development assistance is not possible unless such concrete programs are prepared and submitted to the international community. There has to be a kind of a repetition of the Marshall Plan ambitions, commitment, psychology and fervor. The success of the Marshall Plan lay, at least in major part, in its concreteness, in the clarity of its objectives and in the decisiveness in its execution. Why should it not be possible to work out a similar Plan for Brazil and for several other countries in Latin A America and elsewhere, pushing to the limit of their absorptive capacity, covering a span of 10 years to be followed by another 10 years or perhaps only 5 if that turns out to be sufficient? And is there any other strategy of world development at all?

15. Such a major effort would not be at the expense of other developing countries, i.e. those that are more poor, since the aggregate flow of assistance will be increasing. Furthermore, as experience is acquired in solving the growth problem of a country at $350 income level, it will become easier to approach more systematically the formidable growth problem of those areas that are at $50 per head - the heart of underdevelopment. Also, once it becomes clear, perhaps after a few years, that a major investment effort can be mounted in one part (or two parts) of the world, it is perhaps possible to convince the developed countries that similar effort should be organized, and on a much larger scale, in most developing areas.

16. The advantage of starting with the countries that are most development-ripe is that it can be shown, in the plans and in their execution, that the development problem is soluble <u>within a specified period of time</u>. Perhaps the greatest handicap facing the assistance programs today is the timelessness of the effort which the developed countries are called upon to make. By showing that at least a group of countries can become independent of government-to-government assistance within 10-20 years, confidence in assistance effort may perhaps be restored; and once restored, it will be easier to attack the development problem in echelons at first, and then perhaps along the whole front. As of now, not only we do not have the time dimension, but we do not have even a most approximate idea how much the whole job will cost, and even for a single country. Under these circumstances, we inevitably have questions, at least occasionally, whether the efforts will ever pay, anywhere. As one of the leading personalities in development assistance, deeply committed to the task, once said: "In this business, the most difficult thing is to keep the score. You never know whether you are gaining or losing".1/

1/ Mr. George D. Woods, September 1965, in a private conversation.

17. An alternative development assistance strategy would be to concentrate resources, again on an incremental basis, on those countries which have made most effective use of assistance in the past, irrespective of whether they are at $300 per capita income or only at $50. The difficulty with this criterion is to define what is meant by "made most effective use of assistance in the past". Which have achieved highest growth rate in aggregate GNP? Or highest marginal savings rates? Or highest returns on capital? Or best social equilibrium? Or growth combined with stability? Further difficulty is that a good performance, however defined, over 10 years may be a result of accident and luck rather than of efforts and wisdom. The third difficulty is that if such a successful performer is at $50 per head it will be impossible to specify either the time horizon or the total cost of transformation of the economy - and this, I believe, is a precondition for obtaining more funds from developed countries at the present time.

18. How large is the number of countries on which one concentrates resources depends on the amount of resources one has to spend. From a humanitarian viewpoint, it would be best if we had enough money to push the development effort to the breaking point everywhere in the developing world - provided we are able to organize it on such a wide front. But if we do not, we have to choose among countries. Furthermore, it is the basic thesis of this paper that almost no developed country will today decide to allocate double the present assistance flow unless it is shown first what will the money be used for and what precisely will it achieve. However small may have been the past allocations in terms of needs, they have involved sacrifice on the part of developed countries: and the money has been given on faith rather than on the basis of concrete plans of what development objectives will be in fact achieved. The unpleasant fact must be faced that national legislators are unhappy, rightly or wrongly, both with the results that have been achieved and with the method of collecting funds. The only way this deadlock can now be broken is, in my view, to present concrete and ambitious plans of investment and growth, aiming at structural transformation within a definitive time limit. Only countries at $300-400 income level can prepare such plans, by definition; and it is for this reason that the first concentration of resources should be there. The second concentration should move one step down the ladder. How much time should elapse between the first and the second concentration and so on, is exclusively the matter of availability of funds, the ability of developing countries to prepare concrete long-range plans and the ability of national and international lending agencies to handle on time the much greater workload than they are at present accustomed to.

CHAPTER VII. UNDER WHAT EFFICIENCY CONDITIONS? 1/

1. I am not sufficiently familiar with the Latin American scene to be able to argue in any detail what efficiency conditions should be met if it is decided to increase the resource transfer in response to clearly formulated long-range programs of the Latin American countries. Six broad areas can be identified, however. Three are exclusively internal; one is interregional and two are international in scope.

A. Internal Measures

(a) Liberalization

2. Liberalization of internal economic policies is badly needed. Physical controls, price controls, etc., may be inevitable when resources are very scarce; but they are usually ineffective even in the advanced disciplined societies. In developing countries they are inefficiently administered, they are the source of corruption and they kill incentives. The assumption for elimination of controls, however, is that the aggregate of available resources is increased, i.e., that resource transfers are substantially expanded. Furthermore, liberalization of controls should not mean that industrial protection should be given up (or that the existing commodity arrangements should be abolished and no new concluded). Protection is needed: what is also needed, however, is that it should result from good knowledge of facts and considered national policies rather than from vested interests; and also, that it should be subordinated to regional growth strategy and objectives.

(b) Financial Reform

3. National contribution to development must be increased, as a means of reducing the cost to the international community. There is nothing I can add to the scholarly debate on the need to improve and reorganize the fiscal systems. But I should add that I am somewhat sceptical regarding the realism of the expectations that fiscal reform will quickly yield major new resources. Fiscal experts and donor countries may wish to consider that principal obstacles to additional fiscal efforts are perhaps not so much the lack of knowledge of fiscal theory and practices, but the hard facts of life. You cannot tax business more without affecting incentives to invest which are badly needed; and you cannot tax the consumers more, particularly those that are poor, without courting the risk of wage increases and sometimes riots in the streets. This does not mean that the present efforts at fiscal and monetary reform should be dropped and no new efforts started: both are badly needed. The only thing it means is that foreign advisors should weigh carefully their advice if they are to avoid the repetition of the ugly incidents of the past in which a reasonable advance was sacrificed in vain attempts to carry out sweeping changes overnight, which ended by falls of finance ministers, riots and hate of foreign advisors and agencies, however good their intentions may have been.

1/ The term "conditions" is used in its technical (logical) rather than the legal sense.

4. But if there are limits on tax increases, there should also be limits on increases of government recurrent expenditures. Nobody would argue about the need to increase recurrent spending on agricultural extension or on road maintenance. But what must be argued is that the developing countries simply cannot afford the level and the growth of administrative expenditures, including military (and diplomatic) expenditures, in which they are now engaged. It must be realized that the economic problems of developing countries are of the Smith-Ricardo type; and the Smith-Ricardian precepts must hold. Administrative expenditures must be held down; this is the only painless way - or the least painful way - of increasing recurrent budgetary surpluses for development.

(c) Monetary Reform

5. Inflation must be brought under control and the integrity of national currencies restored. This should be possible if total resources are increased through substantially larger resource transfers from abroad; if lenders agree to finance local currency expenditures to the extent needed to maintain fiscal equilibrium; and if commodity price fluctuations are eliminated or at least greatly moderated. But none of these measures will suffice unless the rise in recurrent government expenditures is brought under control, the losses of public corporations eliminated or greatly reduced and the necessary improvements in fiscal administration and policy urgently undertaken. Above all, there must be political determination to face squarely the competing claims on resources and to do an orderly allocation among them in the budgetary process, rather than to shift the burden of allocation to chance results of inflation and speculation. These conditions are not easy to meet, but it is possible to meet them - unless it is argued that all Latin Nations are inflation-infected. The examples of Mexico - and of Italy and of France with its latest accumulation of dollars and of gold - show how dangerous such sociological superficialities can be.

B. Interregional Measures: Latin American Integration

6. Long-range national plans must be worked out in the regional context. "...Under existing conditions, the leading nations are not much more than settlements along the coasts. They are so effectively isolated from one another that each can more easily communicate with the outer world across the oceans - with North America, with Europe, and even Asia - than with one another. This fragmentation of the continent is the reason why the South American nations, as compared with Europe and North America, are economically and socially backward and politically unstable."1/

7. "...While on the maps South America is a continent, in fact it is not merely an underdeveloped but an undeveloped and unopened continent. The member countries of Latin America are a string of islands surrounded on one side by the oceans and the other by an unpenetrated wilderness. It is easier and cheaper for these islands to trade with Europe or North America than to trade with one another. Thus, for example, in Lima I met a Peruvian pioneer who opened a mine in a valley just across the mountains. There is a large forest only 75 miles away from his mine. Yet, so he told me, it is easier and cheaper for him to import the timber he needs for his mining from Seattle in the state of Washington than from the nearby Peruvian forest. The reason is that there are no roads through the wilderness.

1/ Walter Lippmann, Towards the Making of a Continent, syndicated column of December 16, 1965.

8. "The situation today is as if on this continent there were two strips of settled life, one along the Pacific west of the Rocky Mountains and the other along the Atlantic east of the Alleghenies - with the whole land between the great river system of the Mississippi, the Missouri and the Ohio unusable, without roads, railroads, canals, electric power and telecommunication. If in the United States there were mere wilderness between the Rockies and the Alleghenies, there would be no political union, there would be no great industrial system, there would be no economic base for political stability.

9. "The undeveloped heartland of the South American continent and the fragmentation of the peripheral nations is, I venture to believe, the paramount deficiency. Until this central difficulty is made up, the financial and technical aid provided by the Alliance for Progress and the valiant reforms of the more enlightened of the governments are, I am afraid, no more than palliatives for the pains of what are in fact sick societies."1/

10. There is no inherent reason why most of major new industries, where the economies of scale are decisive, should not be planned on a regional basis, with each country obtaining one or more of these major industries, and the intra-trade in new products free of restrictions. I am referring to steel, fertilizer, pulp and paper, heavy chemicals, automobile production, airplane production. There is also no inherent reason why infrastructure works - power, roads, multi-purpose projects - should not be planned, where necessary, on a regional basis.

C. International Measures

(a) Reorganization of External Debt

11. Several major Latin American countries suffer from acute liquidity difficulties due to high payment obligations on their external public and publicly-guaranteed debt. This has now been the case for years, and there is no relief in sight. In Argentina in 1964, public debt obligations amounted to 37 percent of export earnings, in Brazil probably more. These two countries, as well as Chile (debt service ratio of 22 percent), have been in continuing discussion with their creditors for years. The relief arrangements have normally consisted of postponements of payments on some debts for a couple of years or so, and the liquidity crisis has always re-emerged, with a melancholic monotony.

12. These Latin American countries are the par excellence "cash-squeeze" cases in contemporary international finance. A radical solution to their debt problem would consist of a thorough reorganization of the debt. The creditors have declined to consider such a solution thus far, partly for institutional reasons, partly because of the fear that new short-term debts would be piled up as soon as the obligations on existing short-term debts are postponed.

1/ Walter Lippmann, A Look at South America, syndicated column of December 14, 1965.

13. A major development effort discussed in this paper can hardly be mounted unless the liquidity problem is resolved. It can be resolved without a debt reorganization if creditors are willing to provide freely usable funds which can be applied to debt payments. Which solution is easier is an institutional matter. But whatever is done, it is clear that a sharp break with past practices is necessary. Latin American countries cannot expect the lending agencies - and tomorrow capital markets - to provide them with new loans if they continuously postpone or threaten to postpone payments of old debts. On the other hand, debtors should be helped to pay: the fact must be faced that the present situation, whatever its origin, is not only unhealthy but practically unmanageable. Both parties - the debtors and the creditors - must work out a finance plan for the future which will obviate the need to borrow short-term funds and suppliers' credits on anything similar to the scale resorted to in the past. This may necessitate control and coordination mechanisms, both in debtor and creditor countries, for a short temporary period if possible, for a longer period if necessary. Nobody likes controls: they are an inferior device in resource management. International controls are, in addition, distasteful. But occasionally they are inevitable, if for no other than psychological reasons. However, controls over incurring short-term debt are doomed to failure in advance unless ample provision is made at the same time to make long-term capital available for meeting all legitimate investment and foreign exchange needs, and in a coordinated fashion. One cannot shut down the leaking faucet unless the good faucet can provide all the water that is needed.

(b) Stabilization of Commodity Markets

14. Most Latin American countries suffer from a double squeeze in their external accounts. They are exposed to recurring violent fluctuations in their commodity exports. The majority also suffers from sluggish world demand for their products, against which there is a continuing pressure of supply. This second problem is reflected in slow growth of external earnings and in a longer-term deterioration in the terms of trade. The first problem is reflected in a continuing seesaw of prices and of quantities sold.

15. It is doubtful that developing countries, including Latin America, will in the foreseeable future be compensated, in some automatic fashion, for the long-term deterioration of their terms of trade. The issue is theoretically and statistically controversial; it has now also become charged with emotion on both sides. In fact, if developed countries agree to help finance the major development effort of the developing countries, they will at the same time help finance any foreseen future deterioration of the terms of trade. Does it really matter how financing is called as long as it is there and it is certain that it will be forthcoming?

16. The other issue - commodity stabilization - has a better chance to be explicitly treated and resolved. It is by now almost universally recognized that no developing country can plan properly or execute plans on time in view of their continuing exposure to the vicissitudes of world markets. It is now also accepted, although less universally, that new initiatives are needed to cope with the problem of fluctuations.

17. Latin America is particularly vulnerable to commodity trade. Its major export product, coffee, exhibits, in many ways, the worst features of the commodity problem. The price and the foreign exchange earnings of the producing countries fluctuate widely over the short run, in response to yearly swings in production, typical of tree crops, and to speculative movements in inventories in consuming countries. These yearly fluctuations are super-imposed on prolonged cyclical movements in the world coffee economy, spanning about 20 years each. Relatively brief periods of shortages and high prices alternate with extended periods of surpluses and depressed markets. Finally, there is also a structural problem. As coffee can be easily and profitably grown in vast areas across the tropical belt, and as other investment opportunities in these areas are limited at the present stage of their development, new coffee producers have been entering the world market with substantial quantities. Since this has not been accompanied by a sufficiently fast development of alternative investment and employment outlets in the economically more advanced coffee-producing countries, there has occurred a continuing competitive struggle among old and new producers. They compete for a market whose absorptive capacity, circumscribed in part by tariffs, taxes and quantitative restrictions, has been increasing over the long run, but at a rate lower than the world capacity to produce.

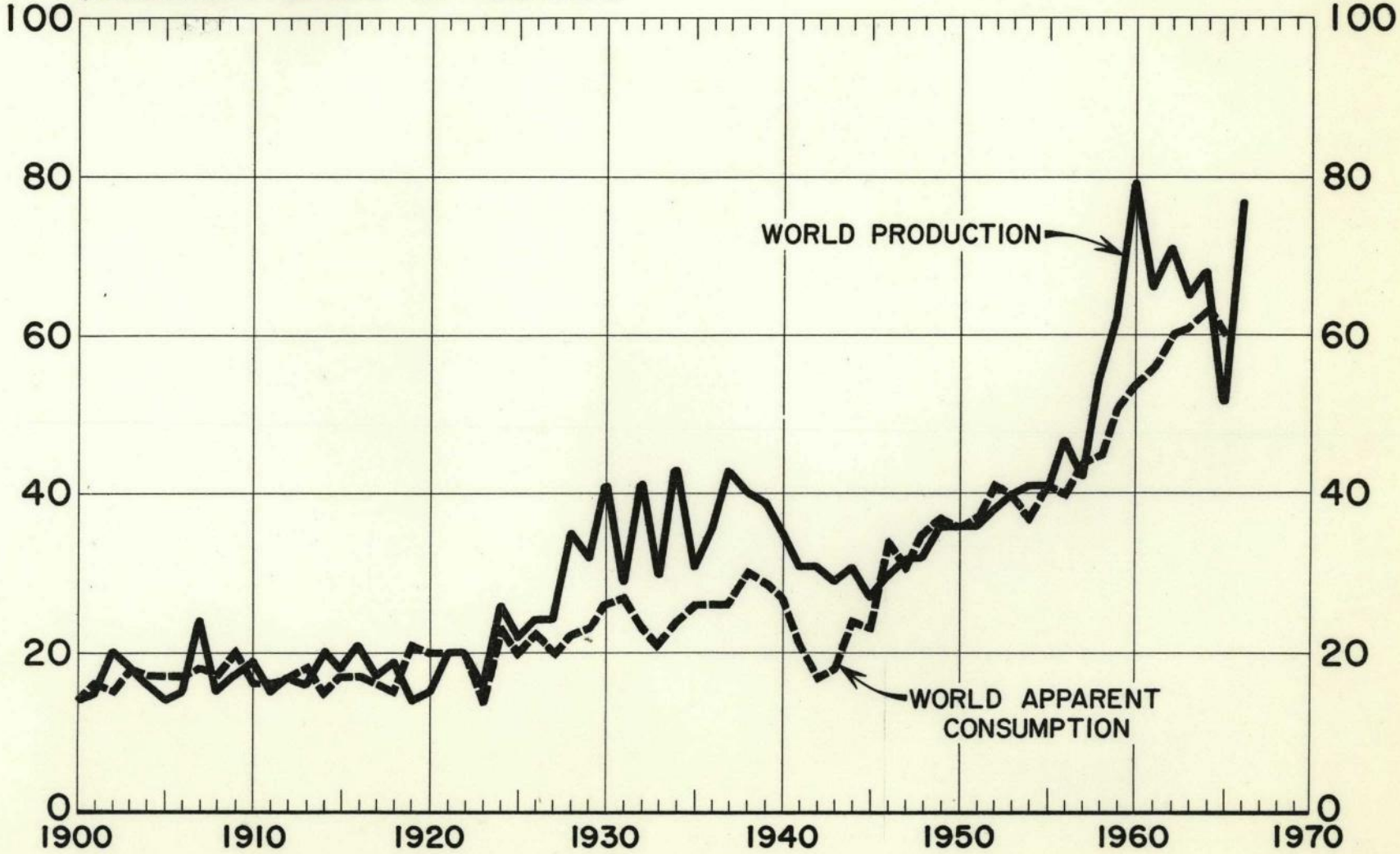
18. Each major primary product presents a problem. The peculiarity of coffee is that it contains a conundrum of problems. In a very few other commodities are the effects of inevitable natural distrubances so powerfully magnified by reactions of the market and particularly of the producers; in an even lesser number of commodities are the resulting price movements so violent; and no other major internationally traded commodity is so strongly influenced by diverse production and sales policies by so many governments. We are here in the presence of a giant Cobweb; and it is far from clear that it may not be a Cobweb of a divergent type, i.e., the world coffee economy may be continuously moving away from equilibrium, due to a particular constellation of demand and supply elasticities, at least over certain price ranges. If so, we are in the presence of the most vicious of all possible disequilibria.1/

19. For eight years, from 1957 to 1962, earnings from production and exports of coffee were falling, year-in-year-out. A major natural catastrophe, destroying almost its whole exportable crop, had to affect Brazil where one-half of world production is still concentrated, for aggregate foreign exchange earnings from coffee to turn upwards in 1963. In 1965, it is certain that coffee earnings will be down again. The tragic paradox of primary product economies is exemplified by the fact that the coffee countries are now producing for export a quantity which is almost double the level of the mid-1950's; and yet, their foreign exchange earnings are still below those realized a decade ago. And a great question mark hangs over the future, unless coordinated measures are urgently taken: to introduce some order in investment and production plans of different producing nations and to attempt to stabilize the world price at some supportable level. Otherwise the International Coffee Agreement, which, helped by bad Brazilian crops recently, had saved the coffee producing countries from a certain catastrophe, cannot look to a bright future.

1/ The term "cobweb" is applied because the changes in prices and outputs over time can be represented diagramatically in a way which resembles a spider's web. The available data on price elasticities of supply and demand for coffee and the prima facie evidence that the coffee cycle may in fact be a divergent cobweb, are given in IBRD, The Commodity Problem, Annex I, Cobweb Theorem, op.cit. The Annex was prepared by Miss Flora White, economist and specialist in commodity analysis on IBRD staff. This whole section has drawn heavily on Miss White's original work, advice and assistance.

COFFEE

(MILLION BAGS OF 60KG.)



NOTE: Prior to 1921 exportable production and net imports.

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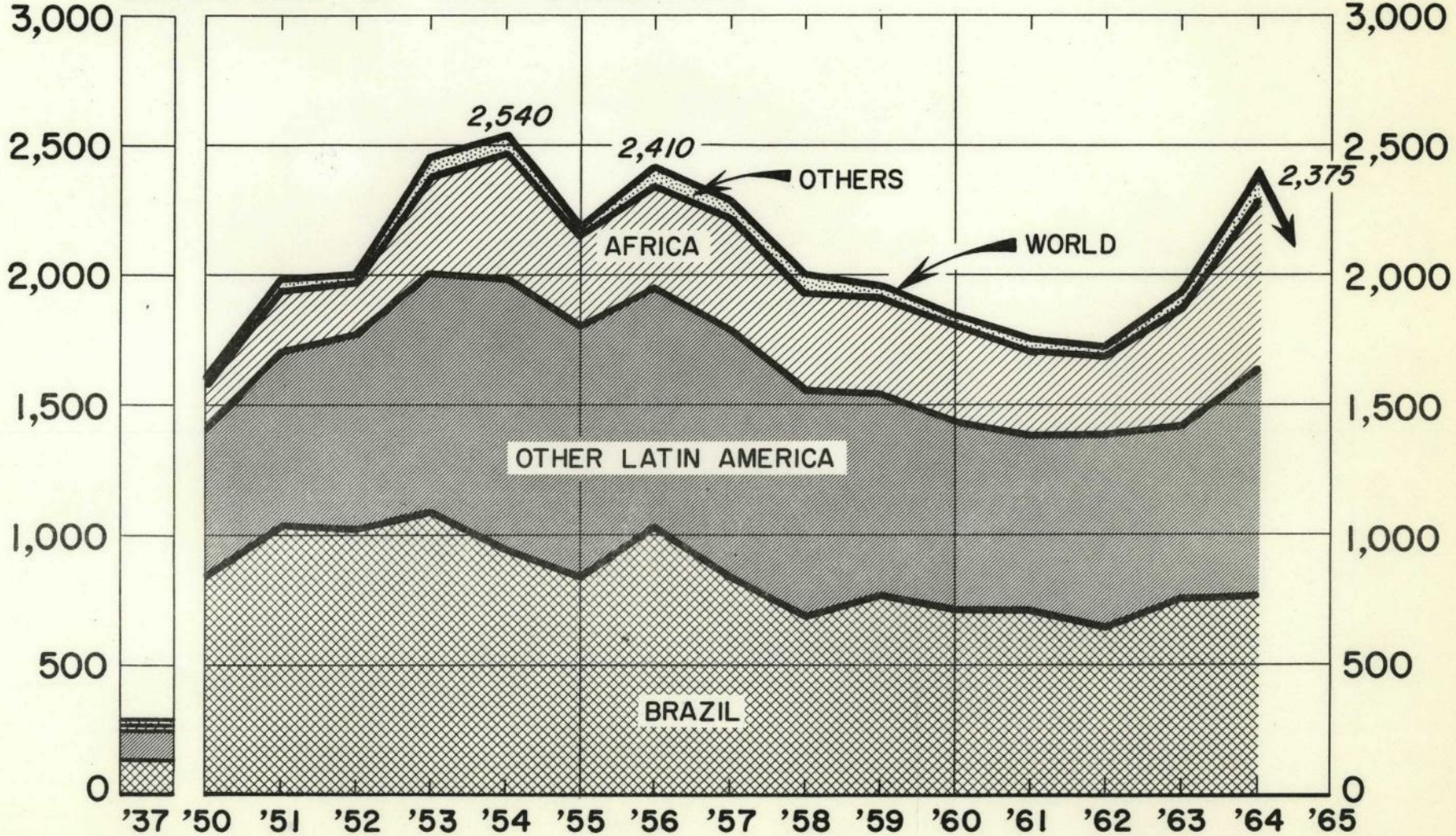
COFFEE: WORLD EXPORT VALUES

(MILLIONS OF U.S. DOLLARS)



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19a. Measures must be taken to subdue the violence of the coffee cycle. It seems to get out of hand when the price is permitted to rise sharply and to stay at a high level for some time: since labor costs are low and do not increase fast due to ample labor supply; and since labor is the chief component of total costs, the price increase is reflected mostly in a manifold expansion of profits; and such swelling of profits leads to massive investment in coffee plantations, which in turn leads, several years later, to an avalanche of supplies and disastrous falls in price and in value of sales. It is at the very beginning of the coffee cycle that the coffee problem has to be attacked: and it can be attacked only if there is coffee in stock which can be sold when there is an incipient shortage, with sales continuing for as long as there is a threat of shortage. For this strategy to work, an international coffee stock is needed; and to accumulate such a stock costs money.

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20. Another commodity example is cocoa - another tree crop, on which West Africa is totally dependent, but which also plays a significant role in Latin American export production. Short-term price fluctuations in cocoa have been even more violent than in coffee:

Price of Cocoa: Year-to-Year Percentage Changes
(Spot N.Y., U.S. cents per lb.)

1954	+55.4	1960	-21.9
1955	-35.3	1961	-20.7
1956	-27.0	1962	- 6.6
1957	+12.5	1963	-18.5
1958	+44.3	1964	- 5.6
1959	-17.6	1965	-26.7

21. It is not only year-to-year gyrations that are violent. Within a single year, 1965, the price went down from 23¢ per lb. in January to 12¢ in July and then back to 22¢ by December.

22. Cocoa price has fluctuated more, over the short-term, than most other primary products during the last two decades; and to make things worse, fluctuations have been around a downward trend which has been more pronounced than in primary products on the average. The cocoa price curve resembles a roller-coaster of a peculiar kind, along a downward slope.

23. "All attempts so far to conclude an international cocoa agreement, protracted over the last ten years in a bitter debate between the producers and the consumers regarding the price at which to stabilize, have failed. Until the solution to the cocoa price problem is found, the producing countries will have to continue to experience violent changes in producers' incomes and in export sales; to maintain fixed debt service payments in the face of these export value changes; and to contract additional debts in order to compensate for occasional export declines, which will in turn lead to higher debt service liabilities. A Bank economist who visited one of these countries in the mid-1950's, said that the country was luck that year: it had a poor crop. This truth still holds."[1]

24. The problem of commodity price stabilization is still open. In the late 1930's and early 1940's, J. M. Keynes, the founding father of the World Bank and of the International Monetary Fund, advocated its solution in the form of international buffer stocks: "...the producers of primary products had a grievance; price oscillations had been excessive in relation to proper economic functions of price movements. The idea of the Buffer Stock plan was to meet the legitimate requirements of primary producers for greater stability, while insuring that, in the long run, prices should move...in accordance with the economic forces."..."If long-run demand was falling, this should be met, not by organized restriction, but by eliminating high-cost producers, with due notice and in an orderly manner. Furthermore, the Buffer Stock plan had a cardinal merit th

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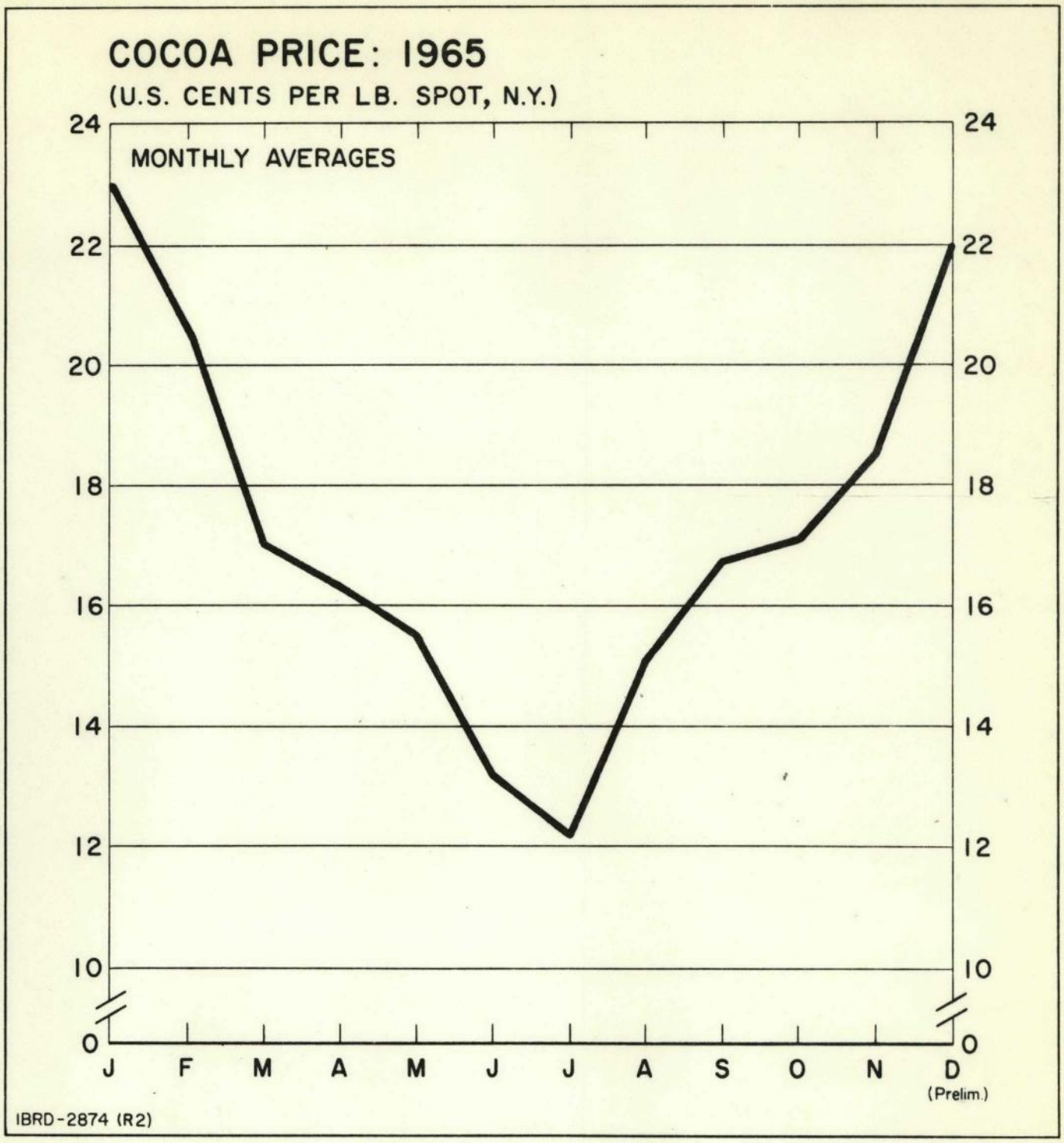
[1] Nigeria, op. cit., p. 45.


COCOA PRICE: 1965
(U.S. CENTS PER LB. SPOT, N.Y.)
MONTHLY AVERAGES
24
22
20
18
16
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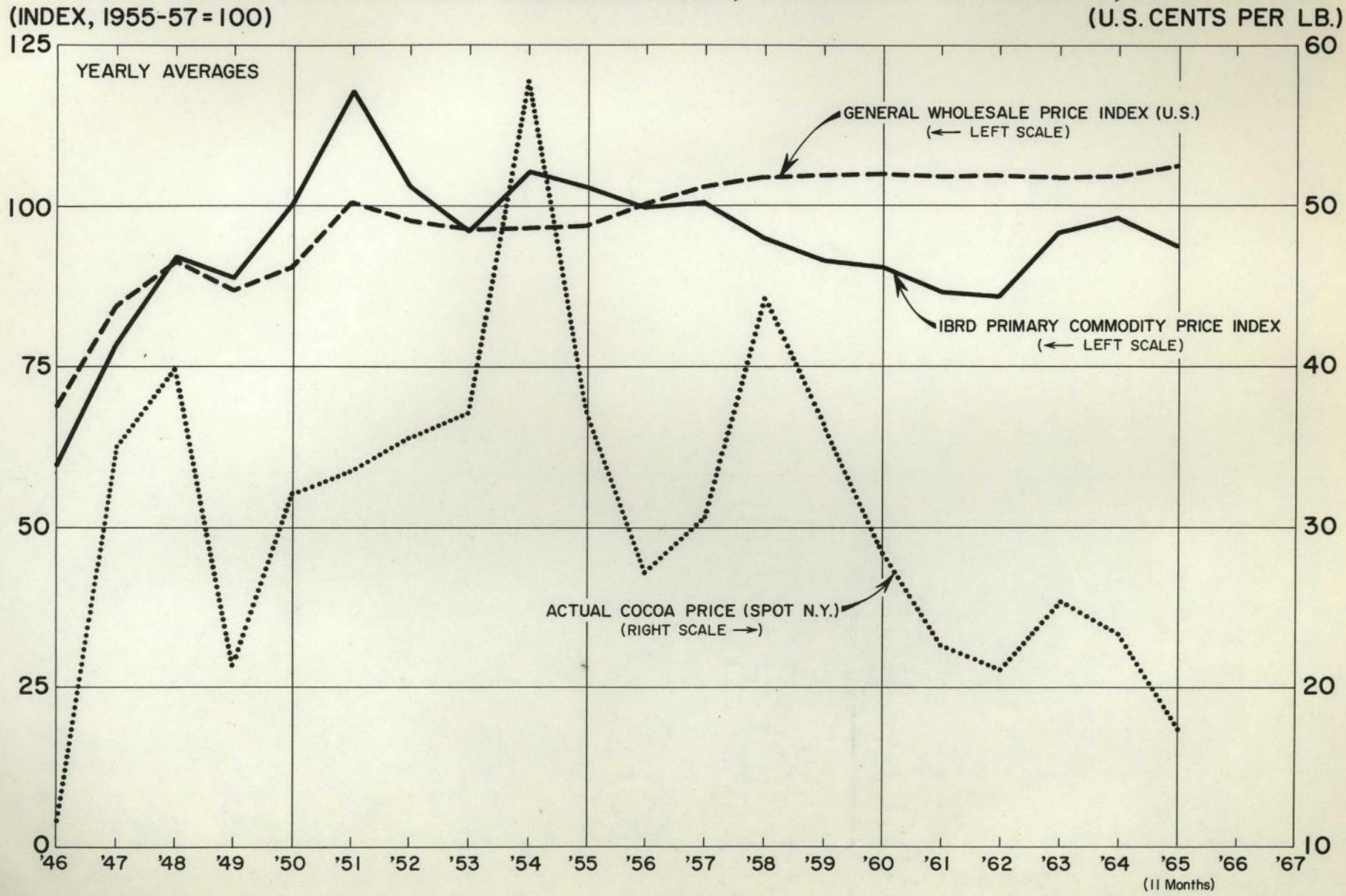
PRICE MOVEMENTS: ALL COMMODITIES, PRIMARY PRODUCTS, AND COCOA



(R) IBRD-2873

it would tend to iron out the cycle in general business. Stock-piling would have an expansive effect in slumps, and releases a damping effect in booms."1/ Keynes, of course, knew what he was talking about: not only did he know intimately the commodity markets as an economic theorist and statesman, but he had also made money in commodity futures.2/

25. Only piecemeal advance has been made in commodity price stabilization thus far, and mostly in the restrictionist direction, i.e. the second or the third best. The issue of buffer stocks is difficult and mistakes can be costly, at least over some time, as national stockpiling schemes have shown. On the other hand, it may be questioned how serious have been the attempts to find international solutions. Compensatory finance schemes represent one approach to the problem of fluctuations: they help insulate development processes from the vagaries of international commodity markets; and they are an effective remedy in cases of crop failures and other breakdowns in export output. At the same time, they leave the price fluctuations themselves, with their disturbing effects on producers and consumers, and with their adverse impact on the use of primary products, untouched; they set in train accumulation of new debts, and in a recurring fashion; and they are more expensive. It costs more to compensate for the loss in the value of sales resulting from unloading a surplus on a weak market, than it costs to hold over the surplus until the market recovers - provided, of course, one does not pay an unreasonable price for the commodity one puts in stock. But what is the reasonable price? This question can probably be answered today within a tolerable margin of error, thanks to econometrics. But can econometrics be trusted? Can computers be trusted? Business seems to trust them.

D. Efficiency Conditions - Concluded

26. The above efficiency conditions - liberalization of internal economic policies, brake on growth of recurrent expenditures and fiscal reform, stop of inflation, regional approach to investment and growth, solution of the liquidity problem arising from excessive debt servicing obligations, and stabilization of commodity markets - must be met if any major new development effort in Latin America is to succeed.

1/ Roy F. Harrod, The Life of John Maynard Keynes, New York, Harcourt, 1951, pp. 531-532. The quotations are from a paper which Keynes submitted at Cambridge in 1938 advocating buffer stocks in commodities, and from an official memorandum on Buffer Stocks which Keynes prepared in the autumn of 1941 for the U.K. Government, apparently proposing an international organization for buffer stocks alongside his proposal for na international Clearing Union which ultimately became the International Monetary Fund. I have not seen the original text of the memorandum.

2/ Harrod, Op. Cit., pp. 299 and 303.

CHAPTER VIII. CONCLUSION

1. At the present time, Latin America draws only negligible resources from the outside world, since capital inflow it receives is used almost exclusively for servicing the loan and equity capital invested there. A hypothesis is put forward in this paper that the major Latin American countries are in principle capable of growing much faster than at present if they get substantial resource transfers from outside: the assumption is that they have the skill and the organizational ability to undertake a level of investment substantially above the present. Another hypothesis is that they can achieve a major transformation of their economies into modern industrial societies within 15-20 years, since they have already overcome the most fundamental obstacles to growth: otherwise they would not have attained a level of $300-$400 per capita income. The assumption is that stagnation in some Latin American countries over the last half a century, unbalanced and halting growth in others, and inflation in almost all, have been due to specific and identifiable causes rather than to some overwhelming sociological complex which would set an absolute brake on progress at the $400 income level. Further assumption is that countries that have lagged can quickly absorb the technological progress which has already occurred elsewhere.

2. In order to achieve such a major economic transformation and to attract external resources that are indispensable for its financing, the main Latin American countries must put forward master plans of investment covering initially a span of 10 years, to be followed by another 10 (or perhaps less), with specific sectoral and project targets, with clearly elaborated policies for growth and with total political commitment to growth as the single objective of the present generation. It is argued in this paper that only if this is done will the developed countries, disillusioned with foreign assistance as they presently are, be prepared to increase greatly the flow of funds and to help wholeheartedly the Latin American efforts. Such master investment plans, to be successful in execution and subsequent operation, must be accompanied by a series of measures of fiscal and monetary reform, focussed on stopping inflation, removing the acute liquidity threats and stabilizing the commodity markets.

3. It is further argued in this paper that the only successful strategy of development assistance that is possible with the present knowledge of facts and sociology is to undertake a concentrated effort at a breakthrough in those countries that are most development-ripe. Here it is possible not only to set specific investment and growth objectives that will mean an economic transformation, but also to set a specific timetable, in which these targets can conceivably be achieved - and to set such a timetable within the foreseeable future. The secret of success of the Marshall Plan was the concreteness of its objectives, the concentration of effort on these objectives and the pre-determined timetable in which the job was to be done. Unless these basic elements of any strategy are applied in the assistance field, there is very little hope for its success. Since these elements can be formulated with tolerable precision at the present time only for countries that are most development-ripe, it is they that will have to be tackled in the first systematic and organized battle against underdevelopment. Such a concentration of effort will not be at the expense of other developing countries, since we are talking here about the increment in assistance, and not about the redistribution of the present flow. Furthermore, once the initial success is achieved in the most development-ripe countries, hopefully even as soon as the effort is organized, it should be possible to attack underdevelopment in other less development-ripe regions; and then, with total concentration of resources and experience, both of developed countries and of those which are already being helped to break through, to attack the great citadel of poverty and human misery and suffering, in South and East Asia.

4. If the resources for development were much more plentiful and the organizational capacities greater than at present, one could risk a much more massive attack on poverty right from the beginning. But, if neither condition is met -- and they do not seem to be met at present -- then it is much better to start on a narrower front first, with less risk and with the intention to acquire experience for the next and more massive attack. Even a decisive advance on a narrower front will represent a most formidable undertaking which defies imagination. If it was easy, it would have been already undertaken years ago.

5. In my view, there is no alternative. The continuation of the present dispersal of stagnant assistance flows wide and thin over the globe is a pseudo-alternative. Since these flows are being eaten away by debt servicing obligations; since the population in developing countries is rapidly increasing; and since there is dissatisfaction with the present results both in developed and in developing countries - we are facing a sure prospect of a continuing decline in per capita assistance. The implications of this are too frightening to contemplate. The spread of famine from India to the rest of the developing world is, in my opinion, the only real alternative to a systematic strategy of assistance. And the fundamental rule of any strategy is concentrated attack first at the point where the enemy is weakest. The enemy - underdevelopment - happens to be weakest, by definition, in countries at $300-400 per capita income. Once that battle is started, the additional echelons can be deployed at the next weakest point and so on, until the whole front is engaged with total commitment of resources, in the final battle.

6. In no war is there a guarantee of success: if such a guarantee was possible, no wars would ever be started.

Atlantic City, April 1966
Revised Washington D.C., May 1966

ANNEX

CAPITAL FLOWS IN LATIN AMERICA,
BY COUNTRY, 1951-1964
(in millions of US$)

Note: No sign indicates capital inflow and resource gap, respectively. Minus sign indicates capital outflow and resource surplus, respectively. The difference between gross capital inflow and net capital inflow equals repayments of principal and repatriation of foreign private direct investment. The difference between net capital inflow and resource transfer equals earnings of foreign capital, i.e. interest, profits and rents, plus salaries of foreign personnel (the latter is negligible).

ARGENTINA

	Resource Gap	Net Capital Inflow	Gross Capital Inflow
1951	191	224	231
1952	401	411	414
1953	-355	-344	-341
1954	- 98	- 83	- 73
1955	220	241	290
1956	115	131	199
1957	290	303	385
1958	228	259	419
1959	- 50	- 10	32
1960	148	205	276
1961	483	585	727
1962	203	275	575
1963	-300	-232	100
1964	-136	- 33	39

BOLIVIA

1951	- 7	- 4	- 2
1952	28	9	13
1953	23	25	36
1954	16	17	32
1955	19	23	30
1956	18	21	36
1957	28	31	48
1958	34	36	49
1959	27	25	37
1960	34	35	48
1961	30	31	52
1962	47	48	61
1963	43	45	61
1964	16	19	25

BRAZIL

1951	315	472	558
1952	591	712	760
1953	-180	- 15	432
1954	100	237	475
1955	- 79	38	243
1956	-144	- 4	199
1957	176	302	549
1958	165	273	609
1959	197	347	779
1960	367	561	1,009
1961	120	304	720
1962	300	499	831
1963	74	218	605
1964	-221	- 88	148

CHILE

	Resource Gap	Net Capital Inflow	Gross Capital Inflow
1951	- 21	46	68
1952	- 83	- 16	39
1953	17	61	90
1954	- 51	1	97
1955	-101	- 23	35
1956	- 84	14	53
1957	75	132	173
1958	35	97	146
1959	- 26	32	120
1960	81	149	213
1961	206	285	361
1962	63	153	304
1963	250	333	461
1964	(0)	(96)	(200)

COLOMBIA

1951	- 41	- 5	23
1952	- 49	- 30	4
1953	- 37	- 14	24
1954	27	42	69
1955	104	127	187
1956	- 3	13	64
1957	-105	- 79	47
1958	-123	- 61	50
1959	- 98	- 62	51
1960	45	85	171
1961	92	142	248
1962	113	170	406
1963	58	139	360
1964	148	240	276

COSTA RICA

1951	- 12	0	8
1952	- 9	6	9
1953	- 10	2	2
1954	- 12	0	4
1955	1	9	11
1956	17	18	20
1957	12	19	23
1958	0	9	14
1959	22	26	30
1960	16	20	26
1961	16	19	29
1962	12	20	29
1963	22	29	51
1964	14	23	34

DOMINICAN REPUBLIC

	Resource Gap	Net Capital Inflow	Gross Capital Inflow
1951	- 33	- 6	- 6
1952	- 9	5	5
1953	- 8	- 3	1
1954	- 25	- 21	- 20
1955	- 2	10	24
1956	0	6	8
1957	- 32	- 20	3
1958	11	14	19
1959	8	6	29
1960	- 56	- 43	- 18
1961	- 55	- 42	- 8
1962	- 5	16	22
1963	28	48	49
1964	58	58	(58)

ECUADOR

1951	- 7	0	6
1952	- 33	- 19	- 15
1953	- 12	2	8
1954	- 1	16	18
1955	4	23	28
1956	3	23	26
1957	- 16	6	12
1958	- 11	11	19
1959	- 19	4	8
1960	- 4	19	33
1961	2	25	42
1962	- 12	8	16
1963	- 8	9	15
1964	37	54	65

EL SALVADOR

1951	- 10	- 9	- 5
1952	- 10	- 8	- 3
1953	- 10	- 7	- 1
1954	- 11	- 8	1
1955	- 4	- 1	7
1956	- 12	- 9	- 6
1957	- 4	- 2	1
1958	- 4	- 1	0
1959	- 4	0	10
1960	25	29	35
1961	- 2	2	6
1962	- 5	0	6
1963	8	14	17
1964	21	27	31

GUATEMALA

	Resource Gap	Net Capital Inflow	Gross Capital Inflow
1951	6	6	6
1952	- 6	- 13	- 10
1953	- 7	- 12	- 10
1954	- 3	- 1	1
1955	6	6	6
1956	22	24	24
1957	38	40	41
1958	47	50	51
1959	34	39	43
1960	21	26	36
1961	16	23	34
1962	15	24	37
1963	16	21	31
1964	30	42	49

HAITI

1951	- 6	0	1
1952	- 1	3	3
1953	6	12	13
1954	- 8	- 6	- 1
1955	15	17	24
1956	- 1	2	7
1957	2	3	8
1958	- 4	- 2	1
1959	- 5	- 2	6
1960	- 6	- 2	3
1961	2	5	10
1962	- 2	4	12
1963	- 5	0	5
1964	4	10	13

HONDURAS

1951	- 16	3	3
1952	- 3	10	10
1953	- 9	5	5
1954	4	0	0
1955	8	7	9
1956	- 5	7	8
1957	12	15	18
1958	5	11	17
1959	- 1	2	7
1960	6	- 3	8
1961	- 1	0	14
1962	- 2	2	7
1963	11	17	21
1964	5	12	14

MEXICO

	Resource Gap	Net Capital Inflow	Gross Capital Inflow
1951	24	124	164
1952	- 21	103	143
1953	26	120	169
1954	- 52	34	90
1955	-241	-148	- 82
1956	- 80	54	136
1957	87	221	336
1958	61	206	382
1959	- 5	164	359
1960	136	326	607
1961	25	229	473
1962	- 64	216	521
1963	- 51	215	500
1964	88	393	(568)

NICARAGUA

1951	- 13	- 7	- 4
1952	- 5	0	3
1953	- 2	5	7
1954	6	12	17
1955	- 9	- 1	3
1956	4	8	18
1957	10	11	20
1958	9	13	19
1959	- 7	- 5	3
1960	8	10	15
1961	5	8	21
1962	10	13	18
1963	4	7	15
1964	8	13	21

PANAMA

1951	9	21	25
1952	13	24	26
1953	4	16	19
1954	2	19	27
1955	- 5	13	18
1956	5	23	24
1957	20	39	40
1958	19	31	43
1959	26	39	43
1960	29	44	48
1961	30	38	45
1962	23	30	33
1963	28	38	39
1964	12	22	23

PARAGUAY

	Resource Gap	Net Capital Inflow	Gross Capital Inflow
1951	- 9	- 8	- 3
1952	5	7	8
1953	5	6	7
1954	4	5	8
1955	1	2	5
1956	7	8	14
1957	8	9	16
1958	12	13	16
1959	5	6	12
1960	10	12	14
1961	9	11	15
1962	4	6	12
1963	7	9	11
1964	9	11	13

PERU

1951	14	36	40
1952	30	50	53
1953	46	66	70
1954	- 5	17	21
1955	16	39	70
1956	64	96	123
1957	117	150	175
1958	79	111	132
1959	- 23	28	69
1960	- 94	- 32	24
1961	- 69	- 12	63
1962	- 44	20	96
1963	- 15	51	132
1964	- 79	- 7	47

URUGUAY

1951	76	80	83
1952	31	36	39
1953	- 74	- 69	- 56
1954	31	36	50
1955	48	53	68
1956	3	8	15
1957	119	124	130
1958	2	6	12
1959	44	50	60
1960	69	76	84
1961	17	23	41
1962	65	72	82
1963	- 5	5	29
1964	- 8	8	26

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1/3/67 - Mr Avramovic said no changes

PRELIMINARY

PROBLEMS IN THE SERVICING OF EXTERNAL DEBT

I. Statistical Background

1. A substantial increase in external indebtedness of developing countries has taken place during the last twenty years, especially on public account. These countries were virtually free of debt as the Second World War ended. At the end of 1965, their aggregate public and publicly-guaranteed indebtedness, including commercial arrears (short-term obligations on which payments were delayed) and the obligation to the International Monetary Fund, was of the order of $40 billion. 1/

2. Growth in outstanding indebtedness and in debt service payments was particularly fast since the mid-1950's. In 1955, the developing countries owed about $10 billion on public account (public and publicly-guaranteed debt with a maturity of one year and over, exclusive of short-term obligations and of obligations towards the International Monetary Fund). By the end of 1965, this debt reached $36.5 billion -- a yearly growth rate exceeding 15%. Debt service obligations on the same category of debt rose from $0.8 billion in 1956 to $3.5 billion in 1965, a four-fold increase during the decade.

A. Growth in Debt

3. Table 1 shows the geographical distribution of the public and publicly-guaranteed debt with a maturity of one year and over at the end of 1965:

Table 1

Total Outstanding External Public Debt (including undisbursed) of 97 Developing Countries as of December 31, 1965 (billions of U.S. dollars)

	Disbursed	Undisbursed	Total
All Areas	27.3	9.1	36.4
Latin America	9.4	2.5	11.9
South Asia and Middle East	8.5	2.8	11.3
Far East	2.5	2.0	4.5
Africa	4.0	1.0	5.0
Southern Europe	2.9	0.8	3.7

1/ Excluding the debts of the centrally-planned economies.

4. A large proportion of aggregate indebtedness is concentrated in about a dozen countries. This concentration is a reflection of a number of factors, with varying significance in different cases. In some, it primarily indicates aggressive foreign resource mobilization in conjunction with an equally aggressive mobilization of domestic sources; in others, it primarily reflects the recourse to foreign resources when domestic resource mobilization lagged behind. For some cases, a major factor has been borrowing to compensate for shortfalls in external earnings - borrowing which could not be repaid over the medium-term as had been originally envisaged. The concentration also reflects the factor of size: large countries are also likely to be large borrowers, in absolute amounts, although not so in per capita terms.

Table 2

Selected Major Debtors: Outstanding External Public Debt (including undisbursed), 1955-1965

(billions of U.S. dollars)

	1955	1963	1964	1965
India	0.4	3.8	4.7	5.2
Brazil	1.4	2.3	2.8	3.0
Indonesia	0.5	1.7	2.0	2.5
Pakistan	0.1	1.2	1.8	2.1
Mexico	0.5	1.6	2.0	2.1
Argentina	(0.4)	2.1	1.9	1.9
U.A.R.	0.7	1.2	1.5	1.4
Turkey	(0.2)	1.0	1.2	1.2
Yugoslavia	0.3	1.1	1.3	1.2
Chile	0.4	0.9	1.0	1.1
Colombia	0.3	0.8	0.9	1.0
Israel	(0.4)	0.9	0.9	0.9
Total	5.6	18.6	22.0	23.6

(a) End of year; figures in parentheses are crude estimates.
(b) Part of 1965 figures are estimates.

5. There has been some apparent slow-down in the rate of debt accumulation in the last year. It is not clear whether this represents a random variation, perhaps reinforced by the weaknesses in statistics, or it reflects the emergence of a new trend, with a slower rate of growth in debt. The latter would result from a continuing increase in debt servicing obligations which is not accompanied by a proportionate rise in gross capital inflow.

B. Growth in Debt Service Payments

6. While debt accumulation of the developing countries as a group slowed down in 1965, their service payments on previously contracted debt rose sharply in 1964 and continued to rise in 1965. The total service payments (interest and amortization) on public and publicly-guaranteed debt with a maturity of one year and over rose from an average of $2.4 billion in 1962 and 1963 to $3.3 billion in 1964 and $3.5 billion in 1965. The most rapid increase in recent years was in Latin America, where debt service in 1965 absorbed about a sixth of export earnings. These figures exclude payments on account of commercial arrears and other short-term obligations: with these, debt service payments would be considerably larger.

Table 3

Estimated Service Payments on External Public Debt of 97 Developing Countries
(billions of U.S. dollars)

	Latin America	South Asia and Middle East	Far East	Africa	Southern Europe	Total
1960	1.4	0.4	0.1	0.1	0.3	2.3
1961	1.3	0.4	0.2	0.1	0.3	2.3
1962	1.3	0.5	0.3	0.1	0.2	2.4
1963	1.3	0.5	0.2	0.2	0.3	2.5
1964	1.7	0.7	0.2	0.3	0.4	3.3
1965	1.7	0.8	0.3	0.3	0.4	3.5

7. The level and growth in debt service payments are a function of the level and growth in debt outstanding and of the terms on which this debt is contracted. On the whole, official assistance for development has tended to become less rather than more concessionary, because of the decline in the share of grants and grant-like contributions (such as long-term credits repayable in local currencies) in the total official bilateral capital flow - from almost three fourths in the late 1950's to about one-half in the mid-1960's. This factor has outweighed the improvement of recent years in the terms of official bilateral loans: between 1960 and 1964 interest rates on official bilateral loans were reduced and the International Development Association, the "soft" credit affiliate of the World Bank commenced operations. However, in 1965 and 1966 the borrowing terms are showing a deterioration.

8. The borrowing terms of developing countries vary sharply by type of debt. For a sample of 34 countries, the weighted average interest rate at which debts were contracted in 1964 was 4.23%, with the range varying from 0.75% (International Development Association) to 6% (privately

placed debt). The average period of grace - the period in which no amortization takes place - amounted to 5 years, but the range varied from less than one year in the case of some private and official debts to 10 years in the case of IDA. The average repayment period was 23 years, resulting from a range from 5 to 50 years.

Table 4

Weighted Average Terms of External Public Debt of 34 Developing Countries by Sources of Finance in 1964

	Contracted Amount ($1,000)	Interest Rate %	Grace Period (years)	Term to Maturity (years)
Total External Public Debt	4,025,480	4.23	5.1	22.8
Publicly Issued Bonds	95,743	5.48	3.0	15.0
Privately Placed Debts[a/]	1,039,018	6.01	1.2	5.8
Loans from International Organizations	1,014,786	3.65	6.7	33.7
World	512,700	5.50	4.6	24.9
IDA	394,590	0.75	10.3	49.8
IADB	87,189	5.38	4.6	18.8
Others	20,307	5.78	0.5	6.6
Bilateral Loans, West	1,861,106	3.50	6.6	26.9
From U.S.	1,225,805	2.69	7.6	30.6
From Others	635,301	5.04	4.6	19.7
Bilateral Loans, East	114,825	3.09	1.5	5.0

a/ Suppliers credits and others.

9. It is likely that the "real" interest rate on privately placed debt is higher than 6% in many cases.

10. The national borrowing terms have varied sharply, depending primarily on the sources of finance. The secondary factors have been differences in national borrowing strategies and in the negotiating position.

Table 5

Weighted Average Terms of External Public Debt Incurred in 1964 by 34 Developing Countries

	Contractual Amount ($1,000)	Rate of Interest (%)	Grace Period (Years)	Term to Maturity (Years)
Grand Total	4,025,480	4.23	5.1	22.8
Africa	354,122	4.92	4.6	25.7
Zambia	7,350	5.74	2.3	25.0
Rhodesia	3,850	5.50	3.5	25.0
Ethiopia	39,210	5.38	4.1	20.3
Nigeria	251,693	5.14	4.2	24.5
Kenya	25,359	4.22	6.1	33.7
Uganda	876	4.10	8.4	31.8
Tanzania	25,784	2.52	8.1	37.8
Asia	1,533,255	3,39	7.0	30.0
Thailand	24,500	5.50	6.1	19.2
Philippines	100,704	5.37	2.8	12.2
Iran	87,738	5.10	1.5	11.3
Israel	106,374	4.48	3.3	13.8
India	546,532	3.30	7.6	33.3
Pakistan	667,407	2.69	8.4	35.5
Latin America	1,467,856	5.06	3.3	15.1
Argentina	18,153	6.08	2.2	11.5
Mexico	567,489	5.96	1.5	8.5
Costa Rica	13,922	5.62	2.0	8.6
Venezuela	70,771	5.53	3.1	15.6
Guatemala	4,785	5.43	3.0	16.9
Peru	153,461	5.31	4.1	16.1
Dominican Rep	91,984	4.64	1.6	8.8
Uruguay	96,372	4.59	1.9	8.6
Nicaragua	13,852	4.47	5.9	23.2
Colombia	194,090	4.19	5.6	26.6
Panama	26,700	4.17	5.3	20.6
Paraguay	16,630	3.81	10.6	25.4
Chile	148,134	3.64	6.1	23.7
Ecuador	45,950	3.42	7.5	33.8
Honduras	5,563	2.06	6.0	21.7
Southern Europe	670,247	3.97	5.1	21.6
Spain	104,113	5.53	3.1	15.9
Yugoslavia	310,454	4.88	3.3	13.3
Turkey	255,680	2.23	8.0	33.9

11. Table 5 does not portray the full picture, in the sense that it does not include receipts from grants: if they were included, the overall terms would be more favorable for the group as a whole, and the position of different countries and regions would also change. The terms would be significantly more favorable for Africa and for Asia than shown in the table, since they are large-scale recipients of grants; the position of the Latin American borrowers would also appear more favorable, but not so strikingly.

12. A significant component of total debt as well as of annual borrowing consists of suppliers' credits, i.e. credits extended by the sellers of machinery and equipment, usually with a guarantee of a public financing agency in a developed country. Export credits today account for probably one-quarter of aggregate indebtedness of developing countries. The share of service payments on such credits in the total is much higher, probably one-half, since these credits are contracted on medium-term and with very short grace periods. The real interest rates are frequently higher than indicated in the contracts, since prices charged for equipment are on a non-competitive basis and sometimes quite high.

13. Debt servicing difficulties usually appear in the form of payments delays on short- and medium-term debt. The maturities on these debts are heavy and concentrated in a short period. Such difficulties are frequently sparked by inflationary pressures in the domestic market, which are not offset by the adjustment in the exchange rate; or they are caused by a sharp fall in external earnings which cannot be compensated by a drawdown of exchange reserves if they are generally kept at a low level.

14. The origin of debt servicing difficulties is usually in the terms on which the debts have been contracted: the worse the terms and the higher the debt service flow in relation to available resources, the more difficult will be the debt management problem.

15. But what are the terms of borrowing that are "supportable" and what is the relationship of debt service flow to available resources that is "safe"? Is there any way in which the limits of borrowing can be determined? Are these limits uniform for all countries? The consideration of these questions revolves around the notion of debt servicing capacity.

II. DEBT SERVICING CAPACITY: LONG-RUN VIEW

A. Concepts

16. The debt servicing problem is essentially the problem of reconciling competing claims on resources. The payment of debt service implies that the borrowing country has to forego a certain amount of purchasing power, which could otherwise be used for consumption or investment. This is the cost of foreign capital to the national economy: against this cost there is the benefit which was derived from foreign resource inflow in the past in terms of an increase in the rate of capital formation, and also the benefit which may be expected in the future from further capital inflow.

17. The problem of reconciling competing claims on resources has a different complexion, depending on the time horizon under consideration. At a point of time, or in a short period, debt servicing difficulties take the form of a liquidity crisis in the balance of payments. Disequilibria in the balance of payments are the heart of the matter. Whether a debtor can overcome the crisis depends on the relative strength of the elements of rigidity (i.e. the contractually fixed external obligations, minimum tolerable level of imports) and counter-wailing elements of flexibility (i.e. availability of compensatory finance and inessential imports). It also depends on the skill of the authorities of the debtor country in managing the balance of payments.

18. Reconciliation of competing claims on resources also has a long-run aspect: and for a developing country this aspect is just as important as the short-run view. Reconciliation of competing claims will be easier when total resources are growing than in a stationary economy. As long as the incidence of debt service falls on a part of the increment in per capita income, it is possible for consumption and nationally financed investment to rise pari passu with service payments. And if the rate of increase in real income, savings and foreign exchange earnings, remaining available after the claims of foreign capital have been met, is reasonably high, if growth occurs in a continuing fashion and if its benefits are widespread, it can plausibly be argued that debt service payments will also be made smoothly. In this case, the opportunity cost of fulfilling external obligations is less obvious and presumably less burdensome than in a situation in which service payments impinge on existing living standards and employment levels. Therefore, it can be argued that continuing growth in per capita production and the underlying process of rapid accumulation of productive capital is the basic long-run condition of debt servicing capacity.

19. The emphasis in para. 18 has been placed on a "reasonably high" rate of growth in real income, savings and foreign exchange earnings, remaining available after debt service obligations have been met. The reason for including, in addition to real income, the variables such as savings and foreign exchange earnings is simple: for debt service to be paid it is not sufficient that additional income be earned, but it must

also be saved rather than consumed: only savings serve as a fund for continued real capital accumulation and for service payments. Furthermore, since most of the debt that is now incurred is debt of the government, it is necessary that public savings be generated and that they rise sufficiently fast to provide both for debt service payments and for financing growing public investment. Consequently, return on capital must exceed the international rate of interest. Finally, since we are concerned with external debt service payments, it is not sufficient that savings be accumulated in total currency: they must also be transferred abroad. They can be transferred abroad either by curtailing imports or by generating additional exports. And since over the long-run growth in income of developing countries is normally associated by an equally fast or even faster growth in the demand for imports, the successful transfer of debt service over the long-run will require an expansion of exports at a rate which, after payment of debt service, will allow the capacity to import to grow sufficiently fast to enable aggregate income (production) to rise at a "satisfactory" ("reasonably high") rate.

20. It is not possible to define in any precise sense what is a "satisfactory" rate of growth: this is a policy variable which will differ from country to country and from time to time. What is possible, however, is to explore the implications of an assumed (target) growth rate (or rates) and of the assumed values of the other variables (savings, investment, return on capital) for the growth of debt and of associated debt service payments, by means a model of economic growth. Furthermore, such a model can approach the reality in a very important direction. A developing country does not satisfy its requirements for consumption and investment and the claims of foreign creditors exclusively out of its own resources. As it maintains service on the previously incurred debt it also continues to borrow abroad. As this process occurs, its debt grows and so does the associated debt service flow.

B. Debt Cycle

21. International indebtedness, its level and its growth reflect the cumulative resource gap, changes in it over time and the terms on which external funds needed to fill the gap are made available. The larger the initial resource gap, the longer the period needed to close the gap, and the higher the rate of interest on borrowed funds, the higher the level of indebtedness and the level of the associated debt service.

22. The length of the borrowing period, the behavior of capital inflow and the size of indebtedness and of debt service can be illustrated by what may be called a debt cycle. Three stages can be distinguished in such a debt cycle; and they are closely linked with the course of economic development.

23. In the first stage, as investment increases, savings, starting from a low level, are inadequate to finance domestic investment requirements. A country has to borrow not only to finance a part of the investment, but also to meet amortization changes and to pay interest on the debt that is accumulated in the process. In this way, it obtains a net addition to its domestically generated resources available for investment. During this stage the burden of servicing foreign capital is continuously postponed. Debt increases very rapidly: since interest on debt incurred previously is paid out of new borrowing which also carries interest, the familiar law of compound interest operates in all its force. However, if an adequate proportion of the newly generated income can be saved, the country would, over time, meet an increasing share of its investment requirements from its own domestic resources.

24. The second stage begins when the domestic savings have grown sufficiently to provide for all domestic investment requirements. In this stage, savings would not, however, be sufficient to meet the entire additional burden of interest and amortization payments on accumulated debt. At the beginning of this stage, debt would continue to grow, but at a slower pace than in the first stage. Towards the end of the second stage, debt has reached its peak and ceased to grow, as domestic savings cover not only the domestic investment requirements but also the entire interest burden on external debt.

25. The third stage is one of declining indebtedness. The savings generated in the economy are sufficient to finance not only all domestic investment and interest payments on external debt but also provide a surplus to retire the debt. Gross borrowing continues for some time, but at a decreasing pace. As gross borrowing approaches zero, the external debt declines rapidly.

26. Chart I shows the three stages of the debt cycle, reflecting the growth-cum-debt model. Income growth rate is set at 5% p.a. (the target of the Development Decade); the initial average gross domestic savings rate is postulated at 10% and the marginal gross savings rate at 20%, i.e. double the average. The gross incremental capital-output ratio is assumed at 3:1 and the gross investment rate at 15%. Foreign capital inflow initially finances one-third of gross investment. It is borrowed at an average interest rate of 6% per annum and average maturity of 15 years, terms fairly representative of conventional lending.

RELATIVE MOVEMENT OF RESOURCE GAP, NET CAPITAL INFLOW AND GROSS CAPITAL INFLOW – THE "MODEL" CASE

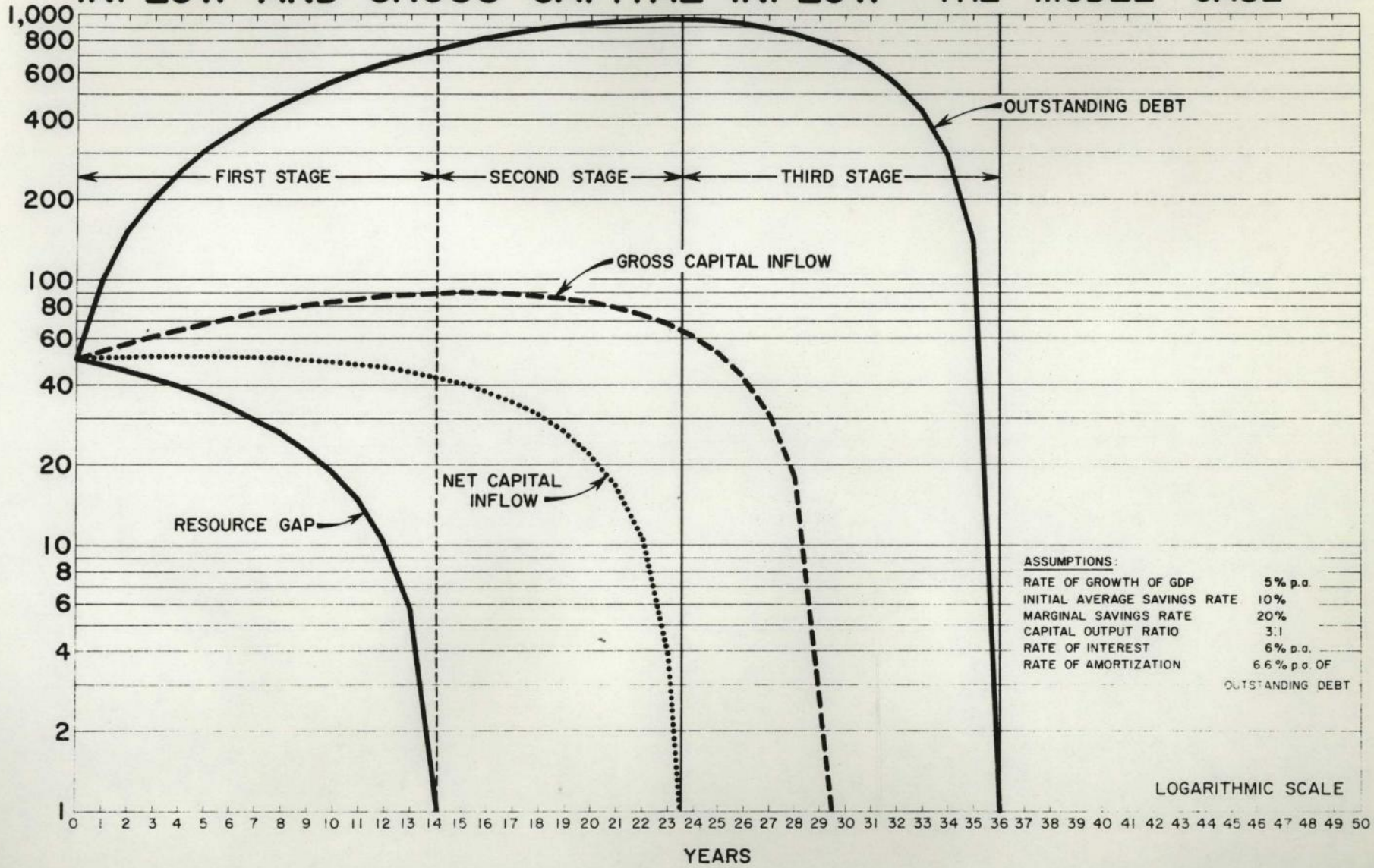

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CHART I

27. With these values for the variables and starting from zero debt, the debt cycle lasts 36 years. The phase in which indebtedness rises lasts about 25 years. This period of rising indebtedness has two stages. During the first 15 years, the country obtains net addition to domestic resources, on top of repayment and interest; in the subsequent decade, borrowing takes place to meet service requirements.

C. The Problem of Productivity and Savings

28. Whether the model variant is representative of reality crucially depends on whether the values for the return on capital (measured here in macro-economic terms by the numerical relationship between capital invested and output generated, i.e. by the incremental capital-output ratio) and for savings rates are properly selected. The debt cycle would last considerably longer and the outstanding debt and debt service would reach higher levels if the return on capital is lower than implied in the incremental capital-output ratio of 3:1 and if the initial savings rate is below 10% and the marginal rate below 20%. And conversely, the period of external borrowing would be shorter and the indebtedness level lower if the productivity of capital is higher and if the income plow-back rate is raised above 20%.

29. In the case of public external borrowing, it is the public savings rate and its relationship to public investment which have crucial significance. Since the possibilities of internal government borrowing in developing countries are limited in the initial stages of the growth process, the public investment-public savings gap essentially determines the need for external borrowing: the larger the gap the greater the demand for externally borrowed funds. On the other hand, foreign lenders are deeply concerned with the trend and the level of public savings. Slow growth in this variable is taken to indicate poor prospects for attaining independence from foreign borrowing and therefore, it is taken to imply almost indefinite prospects of growth in indebtedness and debt service. Under these conditions, the capacity to borrow abroad will be jeopardized.

D. The Foreign Exchange Problem

30. The developing countries experience a number of difficulties - some resulting from poverty itself and some from weaknesses of policy - in raising the rate of savings and in achieving a high rate of return on capital. One particular problem should be singled out: the foreign exchange constraint. The low-income countries are producers of primary products. Consumption of some of these rises very rapidly. Some, however, are victims of Engel's Law of Consumption: their use may be declining, relatively or even absolutely, as income of consumers increases. Some are being displaced by technologically superior and cheaper substitutes. As a result, international demand for the majority of primary products increases at a slower rate than the demand for imports of materials and equipment needed to sustain a satisfactory growth in real income. Lagging exports limit the rate of growth of income, since they limit the capacity

to import the investment goods needed to expand the capacity to produce; and the limit to the rate of growth of income makes it difficult to raise the rate of savings, particularly when the initial level of per capita income is low. Consequently, these countries have to develop exports of manufactured products and of service activities for which international demand rises relatively rapidly. Recent developments in the exports of manufactures and services by developing countries have been very encouraging. However, only a limited number of these countries are at present significant exporters of manufactured products. Countries that are relatively small suppliers of primary products to the world market can expand their exports at a significantly higher rate than the aggregate world import demand and thus alleviate the foreign exchange constraint. For the larger suppliers, it is necessary to develop either alternative primary exports or expand the exports of manufactures. Without this the rapid growth in income can be achieved only by a rising foreign capital inflow. Foreign suppliers of funds may be reluctant to lend, however, if exports are continuously sluggish, partly because such sluggishness implies a low rate of income growth and partly because the rising flow of debt service obligations will be pressing on a stagnating level of foreign exchange earnings.

31. The possible impact of the limitations to obtaining a high productivity of capital, a high marginal savings rate and a high rate of export growth is illustrated in Chart II. It depicts a stylized "long-haul" case in economic development: it is assumed that the low level of per capita income, the high rate of population growth, the obstacles to productivity of capital and its misallocation, the inability to raise the rate of export growth and the difficulties and inadequacies in fiscal policy, tend to prevent a sharp increase in the marginal savings rate. Even in this case, the latter is substantially above the average; but instead of being postulated at double the average (see para. 26), it has been assumed at 60% above the average. A comparison of the projections in the "model" case and in the "long-haul" case shows that the variation of the marginal savings rate from 20 percent (Chart I) to 16 percent (Chart II) more than doubles the period required to close the domestic resource gap. Further, in the "long-haul" case, the build-up of interest payments and of external debt is so rapid that gross capital inflow is a continuing phenomenon and never ceases. The country has become self-sustained in the 37th year, in terms of basic relationship between its domestically generated savings and domestic investment requirements; but it has remained a dependent economy in terms of continuously rising debt to infinity, as long as the conditions defined on Chart II prevail. In cases of this sort, borrowing on conventional terms is bound to lead to increasing debt servicing difficulties over time. Alternatively, the income growth target must be scaled down: but in that case the problem of reconciling competing claims will become increasingly serious in the future. Alternatively still, domestic savings efforts and productivity of capital must be raised. It is the combination of the relaxation of terms of borrowing and of increasing domestic savings efforts and improving the allocation of resources which will yield optimum results from the viewpoint of growth and of the ability to service debt.

RELATIVE MOVEMENT OF RESOURCE GAP, NET CAPITAL INFLOW AND GROSS CAPITAL INFLOW - THE "LONG-HAUL" CASE

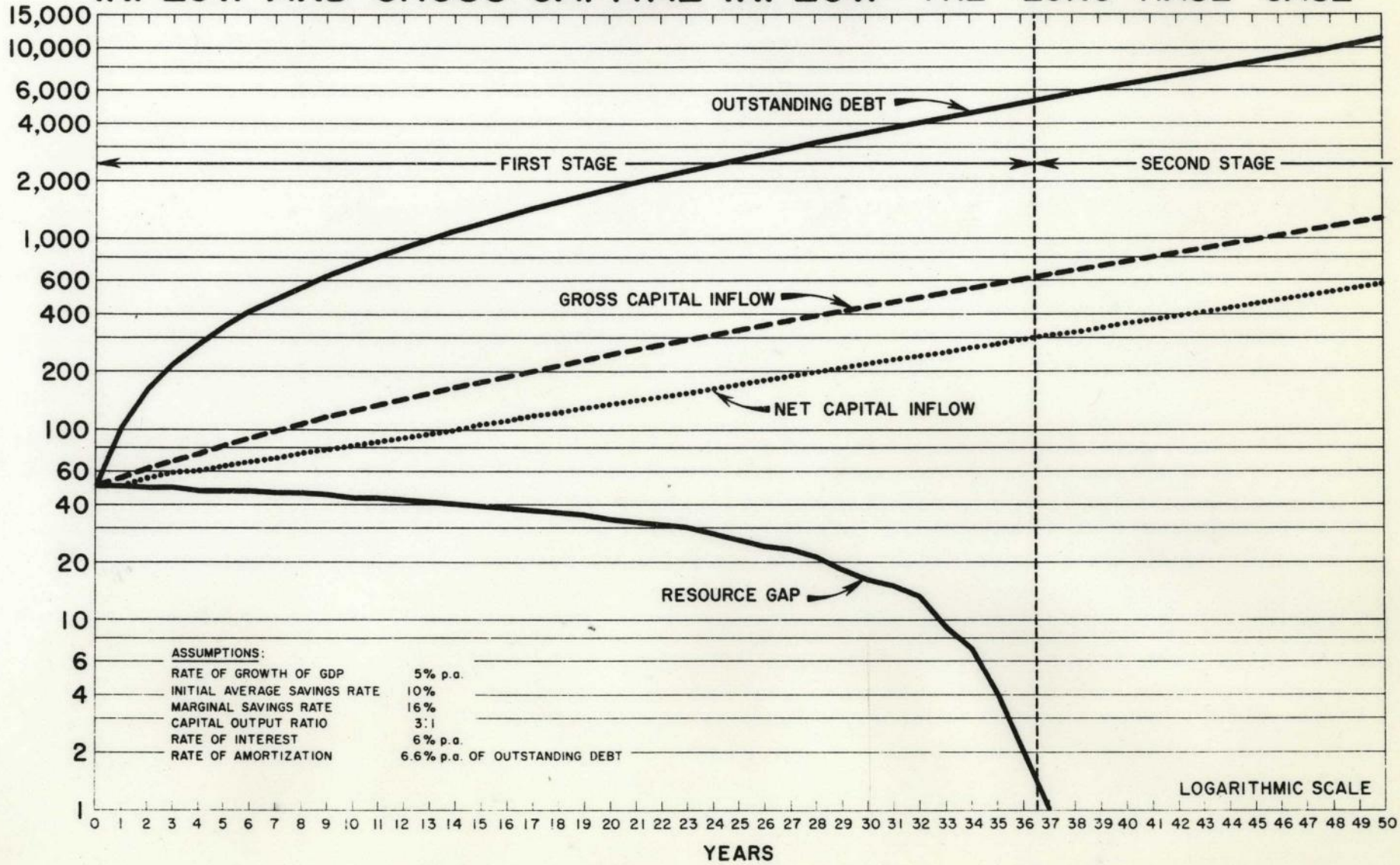

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CHART II

E. Long Run View: Concluded

32. From a long-run viewpoint, four factors have a determining influence on debt servicing capacity:

(a) The return on capital must be higher than the international rate of interest;

(b) The aggregate real income of the economy must grow at a "satisfactory" rate, so that competing claims on resources - debt service, investment, consumption - can be satisfied while assuring a certain positive rate of growth in per capita income; this implies a growing scale of investment;

(c) The savings out of newly-generated income (the plow-back of profits) must be high enough so that at some point in the future - preferably forseable future - domestically generated savings exceed domestic investment requirements and leave a surplus which can be used to meet service payments; and in the case of public borrowing, this surplus has to be generated in government accounts (or internal borrowing has to replace gradually external borrowing);

(d) Exports must grow at a rate which will permit the capacity to import (i.e. the foreign exchange flow remaining after debt service payments) to increase sufficiently fast so as to enable real income to expand at a "satisfactory" rate; such required growth in the capacity to import will be achieved with the help of net foreign capital inflow for some time, but after this period domestic exports must carry the whole burden of financing import requirements.

III. DEBT SERVICING CAPACITY: LIQUIDITY ASPECT

A. Concepts

33. On balance, it can be argued that the majority of developing countries are facing a fairly long period in which they will need external resources to finance their savings and foreign exchange gaps. If this is accepted, it follows that their debt service liabilities will also tend to increase over a long period. Furthermore, if most of the capital inflow is contracted on a fixed servicing schedule, i.e. as loan capital, most of the debt service obligations become contractually fixed. This is the case with most borrowing on public account.

34. Fixed debt service liabilities, if they are of a large magnitude, introduce a serious element of rigidity into the debtor's economy. Since the economic system, and particularly the foreign exchange receipts, continue to fluctuate, while debt servicing obligations remain contractually fixed, the entire impact of downward fluctuations must be born by imports or the country must run a deficit in the current balance of payments.

35. Difficulties in transferring debt service payments at a point of time may result from cyclical or accidental fluctuations in exports and capital inflow, from inflation-induced or accidental rise in imports, from capital flight or a bunching of repayment maturities. Alternatively, the liquidity crisis may be a symptom of structural weaknesses of the economy. These structural weaknesses arise when the conditions for long-run debt servicing capacity, discussed in the preceding chapter are not fulfilled: debt service will account for a larger proportion of income, savings and exports if they stagnate or increase sluggishly than if they grow rapidly; and the larger is this proportion (i.e. the higher the debt service ratio) the more difficult the problem of adjustment in the case of temporary declines in income, savings and exports. And in cases in which the combination of economic variables is such that debt and debt service grow indefinitely (see para. 31), debt servicing crises are inevitable even in the absence of any temporary disturbances in the balance of payments or in government accounts.

36. However, even in a successful long-run growth-cum-debt case, liquidity difficulties may occur and they may be very serious. If the debt structure is unfavorable (i.e. if a large proportion of the total debt is repayable in a short period), if compensatory facilities are insufficient and if export declines, even temporary, are violent - the debt servicing problem may be formidable although the long-term trends of savings, investment and exports may be perfectly consistent with self-sustained growth and may indicate a successful completion of the debt cycle. The balance of payments pressure occurs here just as much as it occurs in the "long-haul" case. The difference between the two cases is that in the pure "cash-squeeze" case the liquidity difficulties are temporary. They could have been avoided, at least in part, by more prudent borrowing policy with respect to amortization terms and they can be remedied through an extension of grace and maturity periods on new loans and,

at the extreme, through rescheduling of maturities on existing debt. In contrast, in "long-haul" cases these measures will not be sufficient. The liquidity difficulties here are primarily a function of continuously rising interest payments on a continuously rising debt, rather than of bunching of maturities in a short period or of a temporary export decline.

B. Liquidity Variables

37. The factors which affect the balance of payments and hence a country's capacity to service debt in the short- and medium-term can be classified as:

(a) Fluctuating (disturbance) variables

(i) exports
(ii) capital flows
(iii) emergency and inflation-induced imports

(b) Offsetting variables

(i) reserves
(ii) compensatory finance
(iii) compressible imports

(c) Rigid variables

(i) minimum tolerable imports
(ii) debt service- interest
(iii) debt service- amortization

38. The economic policy of the borrowing country affects the behavior of many of these variables in a significant manner. In particular, the external financial situation may be aggravated if fiscal and monetary practices are inflationary and their effect on external accounts is not offset by an adequate balance of payments management, e.g., through flexible foreign exchange policies.

(a) Disturbance Variables

39. A major element of balance of payments vulnerability of most developing debtor countries arises from instability of export earnings. Short-term declines in these earnings have in the past originated largely in cyclical declines in international demand. In addition, there have been falls in export receipts caused by occasional failures in supply. Further, a number of developing countries have experienced reduced earnings over the medium term, originating in excess production of primary products in relation to demand. Finally, export declines have been caused by domestic policies which have adversely affected the incentives to produce for exports or to sell on the international market.

40. How far does the experience of the recent past provide a guidance to the future? Falls in exports caused by breakdowns of supply are likely to continue. The problem of medium-term supply-induced fluctuations still exists, and it can be solved only if an advance is made in systematic diversification of the production and export structures of countries heavily dependent on products experiencing medium-term production cycles and if these countries undertake some measure of international coordination of their investment programs and achieve further progress in their joint export sales strategies. Export declines resulting from domestic measures having a restrictive effect on export sales are likely to be less frequent than in the past: in a number of developing countries there is an increasing realization of the need to adopt policies stimulating export growth within the constraint given by the absorptive capacity of the international market. With respect to demand, it would seem that violent business fluctuations, so significant in the prewar period, are not likely to recur: since the Second World War, the industrialized countries have successfully controlled the forces underlying the "normal" business cycle. This does not mean that the problem has been solved, however. Cyclical variations in demand and in business activity in the major world industrial centers still exist, although their amplitude has been dampened; and these cyclical swings lead to alternating upward and downward multi-year price movements which affect all or most commodities simultaneously.

41. The second source of instability is to be found in the capital account. Until the Second World War, capital flows were by far the most sensitive element in the total payments picture, reacting violently to the ups and downs of the business cycle. During a depression, the liquidity problem, frequently originating in the current account under the impact of an export decline, was most seriously aggravated by cessation or even the reversal of capital flows.

42. International capital flows to developing countries as a group have displayed a great degree of stability in the postwar period. The largest component of these flows consists of funds provided by national and international lending agencies; and these funds have not been sensitive to cyclical fluctuations. Frequently, they have tended to compensate for the declines in export receipts.

43. This stability in the over-all flow, however, has not always meant stability for individual recipients. Government-to-government flows are sensitive to non-economic factors affecting bilateral relations. Private direct investment has continued to fluctuate in response to changing conditions in both the capital-importing and capital-exporting countries. Suppliers' credits are sensitive to the short-term balance of payments position of the borrowing country: the terms may become progressively disadvantageous as the liquidity crisis approaches, and the flow is likely to cease when payment difficulties become severe. Thus, while stability in over-all flows is very much greater than in the earlier periods and even the flows to individual countries display greater stability, there are still significant fluctuations in the latter, both with respect to magnitudes and terms.

44. Swings in the flow of foreign capital are not the only disturbance in the capital account of developing countries. Another disturbance which can be of great importance in some countries in particular periods, is flight of domestic capital. It is frequently caused by political factors; but it can also be caused by monetary developments. Countries which have experienced bursts of inflation and successive devaluations would be particularly exposed to capital flight.

45. Domestic inflationary pressures affect not only the capital account but they cause disturbances in the current account as well. Import increases are a natural consequence of inflationary finance if the exchange rate is pegged. There has been an increasing awareness in the developing countries of the consequences of inflationary finance in the recent past; however, inflationary pressures still exist in a number of cases. The impact of this source of instability can be reduced if the balance of payments management is flexible; but even so, a high and continuing degree of inflation will make the external financial position increasingly difficult over time, particularly if capital flight ensues.

46. Some of the disturbance variables discussed above are beyond the control of the debtor country: this refers in particular to export fluctuations that are induced by swings in international demand and to autonomous changes in foreign capital inflow. And conversely, domestic authorities can exercise substantial incluence on some of the variables: this refers to inflation-induced increases in imports and reductions in exports and to capital flight. Only a combination of domestic policies geared to a minimization of internally generated disturbances and of international policies aimed at stabilization of receipts from commodity exports and from capital inflow can assure that the development process proceeds without interruption and that debt servicing obligations are discharged smoothly.

(b) Offsetting Variables

47. As an alternative to stabilization of receipts from exports and from capital inflow, there are three ways in which the impact of export declines and of swings in capital inflow can be offset. The debtor country may build up its foreign exchange reserves in periods of export upswings and use them in periods of decline. Secondly, compensatory finance from abroad can be provided on a loan or grant basis to offset the effects of declines. Thirdly, the debtor country may find it possible to curtail its imports of non-essential goods in periods of decline and thus continue its growth process, although personal consumption, or its growth, may have to be curtailed.

48. In countries where export receipts fluctuate over a relatively short period, if the government of a country conducts an anticyclical policy and has perfect foresight, it may take advantage of a period of above trend exports to accumulate international reserves and pay off short-term debts, and would thus be prepared to face a period of below trend exports. Such

compensatory policy has been in evidence in some developing countries since the war. But this has not been a general rule. With emphasis on economic development and growing need for investible resources, the opportunity cost of maintaining foreign currency and gold reserves has risen, and a number of countries have partly run down such reserves for financing domestic capital formation. In others, reserves have been used to finance excessive import increases: periods of above-trend exports have also been periods of high consumption and investment expenditures, and optimistic expectations regarding the duration of high prices, coupled with imperfections of the monetary mechanism and monetary policies, have frequently led to excessive spending and thus to excessive imports. As a result of these factors, the reserves of developing countries are now substantially smaller, in relation to imports, than they were fifteen years ago: in 1948, they amounted to 70%, they dropped to 57% in 1953 and they are now about 30%.

Reserves as Percentage of Imports, 1964

World	43 %
Industrial Countries	48
Semi-Industrial European Countries	47
High-Income Primary Producing Countries	44
Developing Countries	29

49. Countries' own reserves are not the only offsetting variables. Compensatory borrowing abroad is an effective supplement of own reserves; and the operations of the International Monetary Fund have to a certain extent reduced the need to maintain large reserves of gold and convertible foreign currency. The lack of flexibility introduced by the reduction of own reserves has thus been partly compensated by the establishment and activity of the international machinery specifically designed to supplement the nationally-owned supply of liquidity facilities. Recently, the Fund introduced a new compensatory facility to offset fluctuations in export earnings: this facility is directly aimed at primary producing countries suffering from temporary short-falls in export earnings. Now under way are new international initiatives to create supplementary financing facilities in order to mitigate the impact of unforeseen declines in external receipts.

(c) Rigid Variables

50. It has already been emphasized that the fluctuating nature of external receipts of debtor countries stands in sharp contrast to the fixed nature of their debt servicing obligations. Interest on external debt is the most rigid element in the balance of payments. It is contractually fixed and is a recurring charge on the economy regardless of borrower's fortunes. Fixed interest debt in most developing countries consists today largely of public and publicly-guaranteed debt. Consequently,

any failure to pay this recurring charge adversely reflects on a government's ability to save and to transfer savings, and thus inevitably undermines its credit standing.

51. From the viewpoint of the balance of payments, service on loan capital borrowed by private parties is equally rigid. On the other hand, it is usually assumed that returns on equity capital fluctuate with export earnings. This assumption is only partially valid: it applies to profits and dividends originating in export industries, but it does not apply to earnings of foreign investment employed in activities catering to the domestic market. In the postwar period, such foreign investment has been of significance: it has been flowing not only into consumer goods industries but also into industries producing capital goods and intermediate products in a number of industrializing developing countries.

52. Debt service is not the only element of rigidity in the balance of payments of a developing country. As its industrialization process proceeds, the composition of its imports undergoes significant changes. Expansion of the industrial base requires expanded imports of fuels, raw materials, spare parts and capital goods. Reduced imports of these goods may cause unemployment and affect the momentum of growth. Furthermore, the postwar period has been characterized by a rapid expansion of the imports of foodstuffs into developing countries: domestic food supplies have lagged behind increasing demand. Reduced imports of staple foods is rendered extremely difficult: imported food, in most cases, serves to supplement local supplies to urban centers whose population has grown rapidly since the war.

53. The other component of debt service payments - amortization - is also a rigid element in the balance of payments, although it could be argued that there is a substantive difference between this element and interest. It is the exception rather than the rule that the less developed countries are expected to reduce the absolute level of their debt in the near future, which would happen in the case of net repayment. However, there is no certainty that new loans will be extended and thus offset or more than offset payments due on the loans of the past. The contractual obligation to pay amortization exists irrespective of what happens to other elements of the balance of payments.

54. The most severe liquidity crises are caused by the concentrations of maturities in a short period - the so-called "cash-squeeze" cases. If the debtor country has to repay a large proportion of its debt within a few years; if no foreign exchange reserves have been accumulated to enable the retirement of the debt; and if the creditors are not willing or able to undertake the refinancing of the debt - liquidity difficulties will be acute. Creditors may be reluctant to reschudle the debt over a longer period because of their past experience: rescheduling would not help much if the debtor were to pile up new short-term debts as soon as the existing ones have been funded. On the other hand, the debtor country, if it is unable to space over time the maturities, is almost compelled

to resort to more short-term borrowing, frequently at prohibitive interest rates. Its debt structure worsens further. Breakdown is avoided if the debtor country drastically curtails its imports and thus releases resources for the liquidation of short-term debts; this helps restore its credit abroad, but in the meantime the process of economic growth is arrested. Alternatively, creditors may agree to postpone collections, and this provides a breathing spell. But if new short-term debts are incurred, a new liquidity crisis occurs in short order. This succession of crises inevitably affects the flow of long-term capital needed for development. The solution of the "cash-squeeze" problem is unlikely to prove lasting unless an advance is made in coping with the basic factors responsible for the financial crises that have been experienced.

55. An unfavorable debt structure does not necessarily lead to a liquidity problem: whether such a problem will in fact arise depends on the size of service payments in relation to the major macro-economic variables, particularly export earnings, and on the possibilities of contracting new capital inflow. The latter cannot be statistically measured; they will depend on the circumstances in particular cases. The former can be expressed in the form of the debt service ratio.

IV. DEBT SERVICE RATIO

56. A convenient indicator of rigidity and of the actual and potential pressure on the balance of payments is the ratio of debt service - interest and amortization - to exports. Foreign exchange is one of the scarcest, if not the most scarce, inputs for the developing countries. The debt service is a continuing charge against this scarce resource. The proportion of exports absorbed by debt service reflects the pressure to which a debtor country would be exposed and the effort it would have to make if capital inflow were to cease. Furthermore, since current account receipts also fluctuate, debt service ratio indicates the potential strain which a debtor country would experience when its exports contract: the proportion of export earnings absorbed by debt service would go up when exports decline and there would occur a proportionate reduction in the amount of foreign exchange available to the country for financing imports needed for domestic consumption and investment. Finally, the higher the ratio the greater is the pressure of debt service on the debtor's economy at any point of time.

57. The debt service ratios can attain very high values in the course of the debt cycle. If foreign capital is lent on conventional terms, if the domestic growth variables have the values as described in the growth-cum-debt model (see para. 26), if the initial ratio of exports to income is 10% and if exports grow at the postwar historical rate of 4% per annum, the ratio of debt service to exports would reach 50% at the peak of the debt cycle, i.e. one-half of exchange earnings would be absorbed by debt service (see Chart III). This is a high degree of rigidity. It should be emphasized, however, that if the proportion of exports to total income is higher than 10% - i.e. the economy is more "open" - the level of the ratio would be lower than indicated in Chart III: if the export proportion is 20%, the height of the top line on Chart III (ratio of debt service to exports) would be reduced by half. Similarly, if the rate of export growth is faster, e.g. due to rapid development of exports of manufactures, the ratio would show a more moderate magnitude. Finally, to the extent that lending takes place at a rate of interest below 6%, the ratio would be correspondingly reduced: in fact, the average lending rate is 4-4.5% at present.

58. Debt service ratios of developing countries have been increasing throughout the postwar period: this was inevitable since most countries started with zero debt or very low debt and debt service. For the developing countries as a group, the ratio is now about 10%. For individual major debtors, it is considerably higher, either as a result of an unfavorable debt structure or of the size of the debt outstanding in relation to exports.

RATIOS OF DEBT SERVICE PAYMENTS TO GROSS DOMESTIC PRODUCT, SAVINGS AND EXPORTS

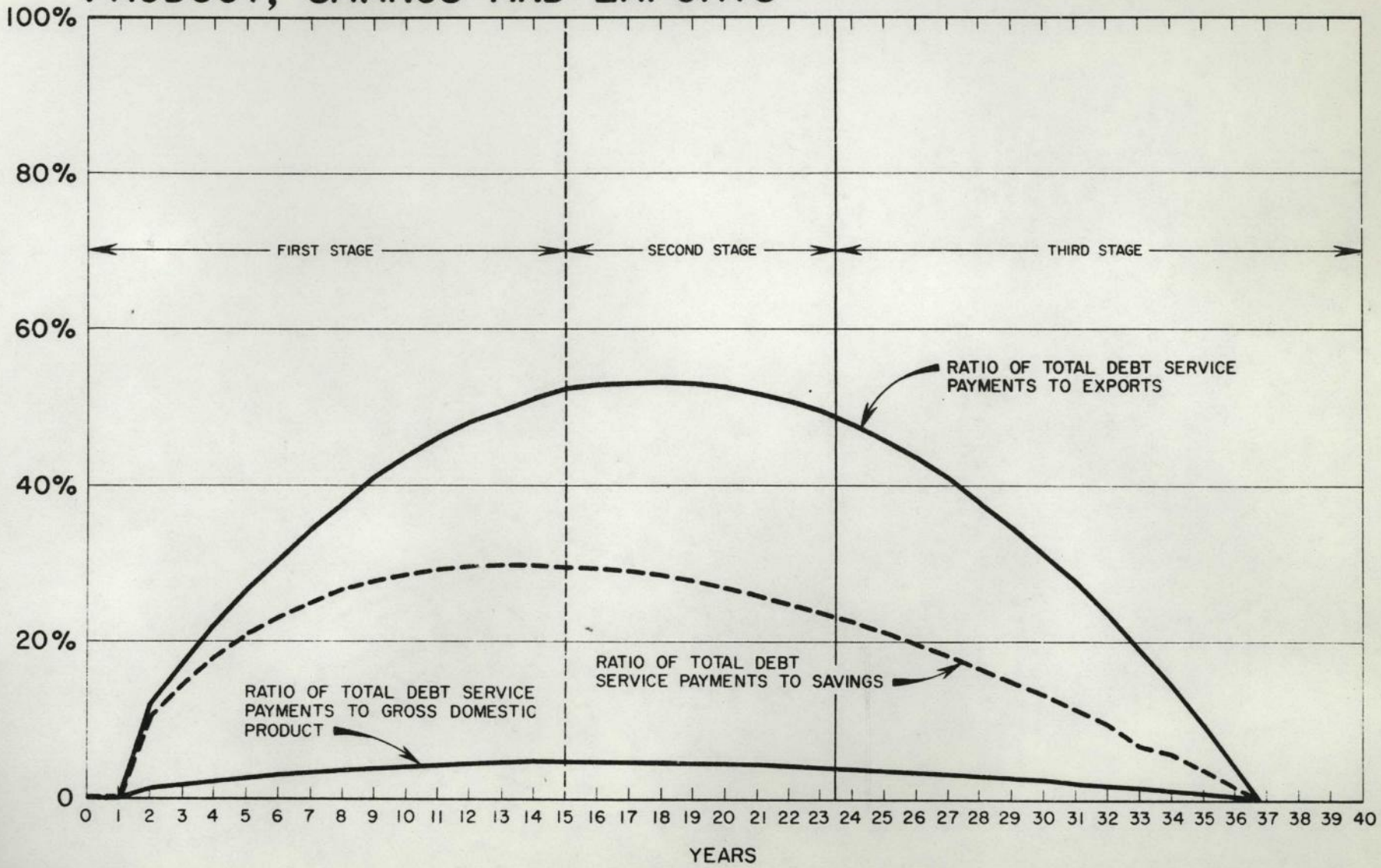

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CHART III

Debt Service Ratios, Selected Countries, Recent Year
(Proportion of Commodity Exports Absorbed by Service on Public and Publicly-Guaranteed Debt, in %)

Latin America			Asia		
Argentina	36.9	(1964)	Israel	32.5	(1964)
Brazil	25.2 a/	(1964)	India	18.8	(1964)
Mexico	24.0 b/	(1964)	Pakistan	14.8	(1964)
Chile	21.3	(1964)	Thailand	3.7	(1963)
Colombia	16.8	(1964)	Philippines	3.5	(1964)
Peru	6.7	(1964)	Malaysia	2.0	(1964)
Southern Europe			**Africa**		
Turkey	26.9	(1964)	Tunisia	15.0	(1964)
Yugoslavia	22.4	(1964)	Ghana	12.9 c/	(1964)
Greece	5.4	(1964)	Sudan	9.3	(1964)
			Nigeria	7.0	(1965)
			Ethiopia	6.8	(1964)
			East Africa	6.6	(1963)
			Morocco	3.0	(1964)

a/ Understated.
b/ Exports include receipts from tourism and border trade.
c/ Scheduled debt service payments in 1965 as percent of 1964 exports.

59. "History provides little guide for determining the maximum ratio which countries can sustain without default or without interference with the transfer of earnings. Argentina maintained investment service in the late 1890's with an investment payment-current receipts ratio of over 40 percent; but the country ... restricted transfers after 1947 with a ratio of only 10 percent (in 1945)... Australia managed to avoid defaults during the 1930's with an investment service-exchange income ratio ranging from 35 to 44 percent during the 1930-34 period; and Canada's ratio reached 37 percent in 1932 without defaults on government obligations or the introduction of exchange controls on current transactions... The degree of tolerance varies considerably from country to country with the breaking point in most countries during the 1930's at 25 to 30 percent. On the other hand, it was a sharp rise in the ratio resulting from the precipitous fall in export earnings that brought about the defaults". 1/

1/ Raymond F. Mikesell, The Capacity to Service Foreign Investment, in: U.S. Private and Government Investment Abroad, University of Oregon, 1962, p. 383.

60. Obviously, high ratios represent a major threat to liquidity at any one point of time. Whether they will be supportable over the short-run, depends on the availability of foreign exchange reserves and of other compensatory facilities. Over the long-run, their supportability depends on the rate of growth in exports and in domestic savings. But they do create serious problems.

61. The problem of rigidities arising from debt servicing burden can be handled in a number of ways. An acceleration in the rate of growth and structural change of the borrowing countries, accompanied by maximum inducement to export development, will tend to increase the flexibility of their economies. Flexible balance of payments management will make it possible to accommodate more smoothly the competing claims on resources and thus to maintain the debt service flow. Avoidance of large-scale short- and medium-term borrowing will prevent the recurrence of bunching of maturities in a short period. Elimination of barriers facing the exports of developing countries, both of primary products and of manufactures, will enable these countries to raise their rate of export growth and thus to reduce the adverse impact of the foreign exchange constraint. Reduction in the amplitude of fluctuations of primary product prices or the provision of supplementary financial facilities will alleviate the difficulties arising from the varying nature of external earnings of developing countries against which they face fixed repayment obligations. Softening of the terms of capital inflow would reduce the rate of growth in external indebtedness and in debt service payments and thus reduce the debt servicing burden and the accompanying rigidities to which it gives rise.

D. Avramovic
September 1966

(Updated) Transcription of talk at Seminar for Brazilian Professors of Economics. Rio de Janeiro 18-22 Sept 1967

Speech A

INTERNATIONAL TRADE, INDUSTRIALIZATION, AND GROWTH

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I. The Controversy

The relationship between industrialization and international trade is an old, controversial subject. But while the controversy is old, the emphasis has been shifted greatly during the last three or four decades.

Debate Prior to World War II

In the period between World Wars I and II, the major question asked was whether industrialization in the developing countries would cause exports from the already industrialized countries to shrink and possibly to stagnate. The next question was whether industrialization would lead to a decline in the exportable surplus in the primary producing countries and thus turn the terms of trade in favor of primary products, raise costs in the already industrialized countries and therefore slow down growth in their savings and in their rate of economic activity.

The first answer to these questions was given by Folke Hilgerdt, in his famous study, Industrialization and Foreign Trade. 1/ Based on extensive statistical investigation covering the period 1870-1935, Hilgerdt arrived at two conclusions:

(1) Industrialization increases productivity of labor, and the resulting greater supply of manufactured goods tends to stimulate the production of primary products for sale. Thus, industrialization tends to increase a country's ability to export and in this way it helps to finance increased imports of manufactures.

(2) The process of simultaneous industrial growth and expansion of trade was disrupted in the 1930s by the disintegration of the world economy. The real danger to the future growth of trade, therefore, is not industrialization but the failure to abolish restrictions on international trade.

At least a part of this old controversy is now virtually dead. World trade has expanded at an extremely rapid rate since World War II: in the decade 1953/55 through 1963/65, world exports rose at a rate of 7 per cent per annum. In the same period, the annual rate of increase for world industrial output was 5.5 per cent; and for gross domestic product (GDP) it ranged between 4 and 4.5 per cent. It follows that trade expanded faster than industrial output and much faster than total product. Furthermore,

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1/ League of Nations, Industrialization and Foreign Trade, Geneva, 1945.

From "Some Aspects of Economic Philosophy of World Bank" Sept. 1968

trade in manufactures expanded much faster than industrial output, rising in the decade 1953/55 through 1963/65 at a rate of 8.6 per cent per annum.

It must be stressed, however, that the fastest expansion was in trade among the industrialized countries and, within this, trade in industrial products. Exports of primary products have lagged behind. Nonetheless, the fundamental point still holds: rapid growth in industrial production and in total real income led to a rapid expansion of trade, not to stagnation.

Postwar Debate

The old controversy has given way to a new one, which has now become quite familiar. There are forces in the world economy that restrict the rate of growth of exports of developing countries and thus set a limit on the growth of these countries' capacity to import, which in turn, sets a limit on the rate of economic growth and of industrialization in the developing countries. Furthermore, there are continuing fluctuations in these countries' exports; and the corresponding fluctuations in their capacity to import interfere with their growth process and thus with the pace at which industrialization proceeds.

What I shall attempt to do here is to consider various elements of this thesis and to draw some of the implications that it contains. Many questions might be raised:

(1) Is the developing countries' elasticity of demand for imports so high that they cannot achieve a satisfactory growth rate without a sharp increase in their capacity to import?

(2) How strong are the forces that keep down the rate of export growth of the developing countries?

(3) How serious are the effects of fluctuations in their export proceeds on their growth process?

(4) How inherent are the fluctuations in the organization of production and trade?

(5) What policy actions could be taken to raise the rate of export growth and to minimize the impact of unforeseen developments in exports on the growth process of the developing countries?

As I cannot cover all these subjects in the time available, I shall leave for discussion the problem of fluctuations and shall restrict my remarks to the problems of import and export growth.

II. Demand for Imports

Shifts in Volume and Composition

In the developing countries, there has generally been a tendency for imports to advance strongly as development programs have got underway. Underlying this tendency has been a shift in the composition of domestic demand towards the kind of manufactures and materials which these countries have been least equipped to produce. In most countries, a major element in this shift has been the increase in the share of investment in total expenditure. Since these countries are largely deficient in the engineering and metal-working industries producing capital goods, the import content of investment is usually high; in recent years it has typically been in the region of 25-40 per cent. Consequently, the shift in domestic demand towards investment has led to a strong increase in import demand for investment goods. At the same time, the industrial and agricultural growth has created new demands for intermediate goods and raw materials, some part of which has had to be met from foreign sources of supply, while demand for food imports has also risen.

Per capita food production in developing countries is now no higher than before the war: in the last several years it has been falling. Before the war, the developing countries were exporting some 10 million tons of grains. Asia and Africa were self-sufficient at a low level of per capita consumption, while Southern Europe and Latin America were large exporters to the Western European market The developing countries are now importing 25 million tons of grains. Part of the Latin American surplus is absorbed within Latin America; Africa, especially North Africa is importing grains; the rice surplus in Southeast Asia has been cut into less than one-half, while India, Pakistan and Indonesia are large importers. The overall swing in grains trade of developing countries amounts to some 35 million tons, or an approximate value of $2.5 billion.

The increase in imports of foodstuffs is a relatively new phenomenon, reflecting in part lags in domestic production. Growth in imports of raw materials, fuels, and manufactured goods in response to industrialization is an old fact. As industrialization has proceeded in a country, imports of raw materials and of fuels -- except in unusual cases -- have risen not only in absolute terms but also as a share of total imports. Between 1913 and 1955, the share of imports of raw materials in a group of semi-industrialized countries rose from 3 per cent to 10 per cent, and the share of fuels increased from 6 per cent to 11 per cent.

The major change, however, has been in the composition of imports of manufactures. The share of textiles in the imports of manufactures of semi-industrialized countries fell from 34 per cent in 1899 to 22 per cent in 1913 and to 6.8 per cent in 1955; and the share of goods other than textiles and capital goods fell from 36 per cent in 1899 to 24 per cent in 1955. At the same time, there was a sharp rise in imports of capital goods -- from 11 per cent of total imports of manufactures at the turn of the century to 43.4 per cent in 1955. But these shifts in composition have not led to a decline in either the absolute value of imports of manufactures or

their share of total imports. In semi-industrial countries, imports of manufactures amounted to 69 per cent of total imports in 1913 and to 70 per cent in 1955. As the total volume of imports rose during that period, the absolute volume of imports of manufactures likewise increased. And in the years 1955 through 1965, imports of manufactures of developing countries as a group rose at a rate of 6 per cent per annum.

Elasticities

The statistical relationship between increase in income and increase in imports has varied greatly from country to country in the postwar period, reflecting differences in resource endowment, in policy, and in growth rates, as well as purely accidental relationships. Some countries have had a rapid growth of output and a slow growth of imports, while others have had a slow growth of output and a rapid growth of imports. However, there are virtually no developing countries in which output grew while imports stagnated or declined over any substantial period of time. (Brazil in the 1950s is perhaps the only modern example, but even this is statistically controversial.) In a sample of some 30 countries covering the period from the early 1950s to the early 1960s, the ratio of import growth to the rate of growth of gross national product (GNP) was typically between 0.5 and 1.5. The unweighted average was 1.25.

Elasticity analyses that have been undertaken show an average value close to 1 or above 1. The United Nations estimate covering the 1950s, broken down by major commodity classes, indicates an aggregate relationship of 1.3 -- imports increasing faster than total real income. Elasticities varied by commodity group -- the highest being that for chemicals (1.85) and the lowest, surprisingly enough, for fuels (0.35). The income elasticity for capital goods imports was above unity in relation to capital formation (1.16); for imports of raw materials, it was quite high (1.65); and, reflecting past lags in domestic agricultural output, it was high (1.49) for imports of foodstuffs. In terms of geographic regions, the elasticity was taken to be below unity for Latin America only; this reflected the past rate of import substitution. The Economic Commission for Latin America (ECLA), in a paper produced in 1963 for the United Nations Conference on Trade and Development (UNCTAD), indicated an income elasticity of demand for imports about equal to or slightly exceeding 1. Demand for capital goods, intermediate products, and fuels would play an important part in determining the future demand for imports, but particularly the demand for capital goods.

Chenery, in the Patterns of Industrial Growth 2/ based on a sample of 47 countries, concluded that imports grow as per capita income rises -- in fact, that both rise at about the same rate. At the same time, dependence on imports is relatively less for a large country than for a small one.

2/ Hollis B. Chenery, "Patterns of Industrial Growth", The American Economic Review, September 1960.

Analyses made by the World Bank of growth performances and future capital requirements of some 47 developing countries have found a past relationship between import growth and GDP growth, on a weighted basis, of just above 1; the projected relationship works at about 1.1 at a weighted GDP growth rate of 6 per cent a year.

The implication of all these findings then is that aggregate income elasticities of demand for imports should be, on the average, somewhat above 1; and for an income growth rate of 5-6 per cent per annum, imports would have to rise somewhat faster than national product. Specifically with respect to manufactured products, two findings seem to be warranted. First, industrialization leads to increased real income per capita; and with growing real income comes an increase in demand for manufactured goods, the rise in per capita demand in developing countries being, on the average, in the region of 1.7-2.0 times that in industrial countries. Second, with the progress of industrialization, the proportion of demand met by imports falls off, the rate of decline being 0.4-0.6 times the rate of increase in manufacturing production per capita. The implications of these results are that, on average, imports of manufactures will rise, since the percentage fall in import content is less than the percentage rise in demand. And since the demand for raw materials and fuels will also tend to increase, total imports will most likely rise even faster than imports of manufactures alone -- and this will occur even if food purchases do not rise.

III. Import Substitution

How does the demand for imports compare with the past and prospective growth in exports? The issue is not, of course, that exports have to rise substantially more than imports: if that were to happen, the developing industrializing countries would quickly cease to receive from abroad any contribution to their resources. The issue is whether exports can rise at a rate reasonably close to the rate of growth of imports so as to prevent the external gap from rising to unmanageable proportions; and whether a rapid growth in exports will improve the flexibility of the economy and reduce the need for an extreme policy of import substitution. Import substitution is both necessary and inevitable in the process of growth and industrialization; on the other hand, it has its limits. In terms of industrial structure, import substitution becomes difficult and costly within the confines of national markets when pushed beyond a certain point. As Raul Prebisch said at UNCTAD in 1964 (basing his statement mostly on Latin American experience):

"(a) The simple and relatively easy phase of import substitution has reached, or is reaching, its limit in the countries where industrialization has made most progress. As this happens, the need arises for technically complex and difficult substitution activities, which usually require great capital intensity and very large markets if a reasonable degree of economic viability is to be attained. Thus there are limits to import substitution in the developing countries which cannot be exceeded without a frequent and considerable waste of capital. Moreover, the extension of import substitution to a wider range of goods generates or increases demand for other imports, whether of raw materials and intermediate goods to

manufacture products in respect of which such substitution is taking place, or of new lines of capital goods or consumer goods that technology is constantly creating.

"(b) The relative smallness of national markets, in addition to other adverse factors, has often made the cost of industries excessive and necessitated recourse to very high protective tariffs; the latter in turn has had unfavorable effects on the industrial structure because it has encouraged the establishment of small uneconomical plants, weakened the incentive to introduce modern techniques, and slowed down the rise in productivity.

"(c) Usually industrialization has not been the result of a programme but has been dictated by adverse external circumstances which made it necessary to restrict or ban imports; these measures have been applied especially to non-essential imports that can be dispensed with or postponed. Thus home production of these goods has been encouraged, absorbing scarce production resources, often regardless of cost."

This statement does not apply with equal strength to all countries. In the larger of the developing countries, the room for efficient import substitution will be much wider, not only for consumer goods but for producer goods as well, than it will be in the smaller countries. But even in the larger countries, there will be frequent cases of inefficient and high-cost operations unless industrial programming is extremely careful; also, after a certain point, imports -- already restricted to such goods as intermediate products, fuels, and high-quality capital goods, which the country either cannot produce at all or can produce only at exhorbitant cost -- will tend to increase as domestic investment and production increase.

Many factors have brought about the type of import substitution policy that has been adopted in the developing countries in the past. One of them has been their export experience.

IV. Export Experience

The aggregate value of exports of developing countries has been rising in the postwar period at a rate of about 4.5 per cent per annum. Within this aggregate, the various regions have fared quite differently. Exports of the Middle Eastern countries have expanded at twice the average rate, i.e. 8 per cent per annum. Those of African countries, which have displaced in part producers in Latin America and Asia, have risen above the average rate. Latin American and Asian exports have increased much less -- an average growth rate of 3 per cent to 4 per cent per annum. In a number of cases the postwar growth in exports has been lower than the rate of population increase.

Many factors determine the rates of export growth. One set of forces is beyond the control of policy; another set is subject to policy measures. The distinction between these two sets of forces is not watertight, but for analytical purposes it is necessary.

Forces Beyond Control of Policy

An important force that is beyond the control of policy is the slow rate of increase in developed countries' demand for certain types of food -- ordinary food. This demand is subject to Engel's Law of consumption: a diminishing proportion of income is spent on foodstuffs as income rises above a certain level. Exporters of ordinary foodstuffs -- for example, cereals, oils, and fats -- to high-income areas face an inelastic demand schedule. Furthermore, an increasing part of expenditures on food is absorbed by the services component. However, there are two exceptions to Engel's Law:

(1) The income elasticity of demand is quite high for certain foodstuffs -- those with high vitamin and protein content. Citrus fruits, bananas, pineapples, and meat belong to this category. Unless there are either insufficient incentives to produce or barriers to the flow of trade, exports of these products can expand relatively rapidly.

(2) Engel's Law is a law of consumption, not of trade. A slowdown of production in the importing areas or in competing developed exporting countries can open room for rapid export growth from the developing countries, provided again that these are sufficient incentives to produce and no trade barriers.

Nonetheless, the effects of Engel's Law will be to keep down the rate of growth of exports of foodstuffs at the present international distribution of income.

Another force that is beyond the control of policy is technical progress in the importing developed countries. On the one hand, chemical and engineering industries, which enjoy the fastest rates of growth, have a low ratio of materials to value added. This is in contrast to textiles and other nondurable goods industries in which growth rates are lagging and which have a relatively high materials content. On the other hand, there is a trend toward a lower volume of consumption of materials per unit of output: increased use of waste materials, a trend toward lighter products, an increase in the degree of fabrication of industrial products. In technically advanced sectors, this force has been most important. Bulk handling is another example. Finally, consumption of services rises faster than consumption of goods, and this reduces the rate of growth of inputs of materials. The net effect of all these factors is illustrated by the following: in 1900, the United States used 22.5 cents worth of raw materials for each dollar of GNP; in 1960, it used only 11.5 cents worth. This downward trend has accelerated in the last 20 years. The United States economized in the use of raw materials at a rate of 0.1 per cent per annum from 1900 to 1940, and since then at a rate of 1.8 per cent per annum.

Another -- and most outstanding -- technical change has been the continuing development of new types of synthetic materials. This has been true particularly of man-made fibers, both the cellulosic and the newer noncellulosic types, which have made considerable inroads into the traditional apparel uses of cotton and wool in the developed countries; synthetic rubber,

Forces Within Control of Policy

Policy actions both in the developed and in the developing countries, influence the growth of exports. I shall discuss first the policies of the developed countries, and then move to those of the developing countries.

Policies of the Developed Countries

Seventy per cent of the exports of developing countries are directed to the developed areas; consequently, the trade policies in these latter areas influence heavily the export earnings of developing countries.

1. Trade Restrictions on Primary Products

Restrictions by developed countries on imports of primary products -- which account for some 88 per cent of developing countries' exports -- are of many kinds; they include tariffs, quantitative restrictions, excise taxes, and other devices, and their complexity and severity vary from commodity to commodity. All of these measures tend to restrict the volume of exports from foreign suppliers. In addition, quotas and other quantitative restrictions -- by transferring from domestic producers to the world market some of the burden of adjustment to changing conditions -- increase the instability of prices in the world market and hence aggravate the instability of export earnings from primary products. The potential export earnings of producers of primary raw materials are further restricted by the practice of imposing tariffs on processed goods which are higher than those on raw products; this encourages the importing of products in raw rather than in processed form. In the early 1960s, 40 per cent of the value of foodstuffs and industrial raw materials imported by major industrial countries from developing countries was subject to some form of restriction. For foodstuffs particularly the restrictions were extensive, covering 56 per cent; for industrial raw materials, the coverage was less -- some 22 per cent.

Price support. The wide variety of forms of protection makes it difficult to identify with any degree of precision the importance of protection in different countries, and for different commodities, in restricting access to the import markets. Since, however, the underlying purpose of all forms of protection is to maintain producers' incomes -- by raising prices or by direct income support -- a reasonably approximate method of assessing the level of protection may be obtained from data on price support to domestic producers of particular primary commodities. 4/

In 1963/64, the weighted average price support for wheat, sugar, milk beef, pork, and eggs amounted to 52 per cent in countries in the European Economic Community (EEC), 36 per cent in countries in the European Free Trade Association (EFTA), and 18 per cent in the United States. This compares with the following values in 1956/57: 35 per cent (EEC), 40 per cent (EFTA), and

4/ See UNCTAD, The Development of An International Commodity Policy, 1967.

21 per cent (U.S.). Thus, in EEC, the protection increased; in EFTA and the United States, it fell somewhat. Insofar as developing countries are concerned, the protective policies for sugar, meat, vegetable oils, citrus fruit, and tobacco are particularly damaging, since in these products they could be competitive and the elasticity of supply should be substantial.

Revenue charges on primary products. For tropical agricultural products, the main barriers to exports of the developing countries are the excise taxes imposed by developed countries on coffee, cocoa, bananas, and tea. Also subject to revenue duties are sugar, oilseeds, wine, and, particularly, tobacco and petroleum. In the early 1960s (1962), nine major developed countries collected about $7.2 billion from revenue duties and internal fiscal charges on primary commodities imported from developing countries. Most of it was raised on petroleum and tobacco (some $5.9 billion); coffee and sugar yielded about $450 million each.

Effects of removing protection on primary commodities. Various estimates have been made of the effects of removing protection. They depend on assumptions concerning price elasticities of supply in both developing and developed countries, and of demand in the developed countries. Gale Johnson, president of the American Farm Economic Association, has estimated the effect on imports of removing protection at $3.5-4.5 billion, of which about one-half might accrue to developing countries. This is a global estimate; it is based on the assumption that the elasticity of supply in developed countries is 0.15, that the elasticity of demand is 0.2, and that price supports raise the price to the producers by 20-25 per cent and to the consumers by 15-20 per cent. It is also based on the assumption that the elasticity of supply in the developing countries is very high. The difficulty is that it is not possible to break down such global estimates. Specific estimates have been made with respect to sugar: depending on the assumptions as to whether protection would be completely abolished (with an accompanying assumption that, if the price should fall to 5 cents, domestic production would be wiped out in five major importing countries) or just the form of protection would be changed (use of deficiency payments, thus reducing the price and raising consumption, without reducing output in developed countries), the estimates for additional export earnings range from $675 million to $80 million a year. For coffee, cocoa, tea, oranges, and bananas, the abolition of fiscal charges would yield some $120-125 million; the amount is low because price elasticity is low. If, instead, one-half of the revenues were transferred to the producing countries, the amount would exceed $350 million.

2. Trade restrictions on manufactures

Barriers to exports of manufactured products from the developing countries, like barriers to exports of primary commodities, include both tariff and non tariff restrictions. It is impossible to generalize concerning non tariff restrictions and their effects. They include licensing requirements, quota restrictions, negotiated export limitations, internal taxes. The most important ones are probably quota restrictions and negotiated export limitations; among these is the International Cotton Textile Agreement, which provides for restraint on exports in the event of market disruption in the importing developed countries. Despite this agreement, exports of textiles

from the developing countries have risen rapidly; but there is no doubt that they would have increased much more if the restrictions did not apply.

Insofar as tariff barriers are concerned, the general level has been declining in the postwar period. In the United States and Western Europe, they now range between 10 and 15 per cent. However, a distinction must be made between nominal and effective protection, and also between tariffs on different classes of goods.

The concept of effective protection concerns different levels of protection at various stages of fabrication. Rates of duty typically rise from raw materials to semimanufactures and from semimanufactures to finished goods. Escalation thus gives effective protection at rising rates -- and at rates higher than the nominal tariff on the goods -- to goods at successive stages of the production process, with greater effective protection being given to consumer goods than to capital goods. These tariff structures then tend to affect unfavorably higher stages of fabrication that are labor intensive.

In 1962, the average nominal tariff of the Unites States was 11.6 per cent; the average on imports from developing countries was 18 per cent. In the EEC, the respective figures were 12 per cent and 15 per cent; in Japan, 15 per cent and 18 per cent. The average overall tariff in a group of industrial countries was 11 per cent and the tariff of imports from developing countries 16 per cent. For this group of industrial countries, the effective rate -- calculated on value added -- on all imports of manufactures was 19 per cent, i.e. 68 per cent higher than the nominal rate; but the effective rate on imports of manufactures from developing countries was 32.8 per cent or about 100 per cent above the nominal rate of 16 per cent.

Obstacles to trade lower the ceiling on international demand and thus aggravate the foreign exchange difficulties of the developing countries. At the same time, they introduce distortions in the pattern of resource allocation in the world economy; and this distortion affects the developing countries severely because their capacity to adjust to obstacles is limited. Factors are less mobile, institutions are less adaptable, and skills are much more scarce in these countries than in the advanced, industrialized countries. Indeed, the relative absence of resilience and dynamism is one of the most important characteristics of low-income primary producing countries; and the greater the obstacles to the deployment of their resources in accordance with the principle of comparative advantage, the more difficult will be the solution of their growth-cum-trade problem.

Policies of the Developing Countries

With full recognition of the facts that the constraint on world demand for primary products and the barriers to trade in manufactures exert a dominant influence on exports of developing countries, the question still arises: could not these countries as a group -- and also as particular countries -- have done better in the postwar period? The share of developing countries in total world exports fell from 27 per cent in 1953 to 20 per cent

in 1965. At the same time, the share of Latin American exports in total exports of developing countries fell from 36 per cent to 30.5 per cent. A decline was inevitable, given overall trends in demand and trade. But was it inevitable that the decline should be so pronounced?

Decline in Share of Exports of Primary Products

The decline in the developing countries' share in world exports was due not only to the fact that trade in manufactures among the developed countries expanded very rapidly. There was also a decline in the developing countries' share in trade in primary products, with the exception of fuels. Between 1953-55 and 1959-61, the volume of exports of primary products, excluding fuels, from developed countries rose at a rate of 6.1 per cent per annum and between 1959-61 and 1963-64 at a rate of 5.2 per cent. In the same periods, the respective growth rates for exports from developing countries were 3.3 per cent and 3.6 per cent. In value terms, the difference was greater, export prices of developing countries declining compared to export prices of developed countries. While there was a constraint on overall world demand, the developed countries were more successful than the developing countries in operating within this constraint. A part of the explanation is the different composition of exports; another factor is the growth of sales of agricultural products on concessionary terms. Perhaps most important, the developing countries specialize in a relatively narrow range of products which are then exposed to prolonged price weakness. Nonetheless, the impression is that some developing countries experienced difficulties in supplying some products; and that where supplies were available, the developing countries were less able to defend the prices of their exports.

Differences in Countries' Experiences

There is yet another way of looking at the problem. Among the developing countries there have been very wide variations in the growth of exports of primary products: some countries have been very successful and some have shown low growth rates. The variations among countries are particularly striking, since, in exporting, all of them must overcome common obstacles. Similarly, in exports of manufactures, all of the developing countries have faced difficulties of entering new, highly competitive, developed markets, because of barriers on trade. Yet certain countries have shown outstanding results in developing exports of manufactures, while others have been lagging behind.

An analysis of the export experience of 29 developing countries was carried out in the World Bank. 5/ It focused on a country's share in the markets for its major export commodities, on the size of the country's internal market, on the rates of growth of industrial and agricultural

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5/ Barend A. de Vries, The Export Experience of Developing Countries, World Bank Staff Occasional Papers, 1967.

output, and on the degree of price inflation. The period covered was 1950-63. The results were as follows:

(1) The development of exports appeared to be associated with the initial share that a country had in the markets of major commodities: countries that initially had small market positions tended to fare better than those with large initial shares in major markets. Brazil's position in the coffee market immediately comes to mind: the constraint imposed by Brazil's need to maximize foreign exchange earnings, by withholding supplies, led to sluggishness in the export of a major commodity and to a decline in the share of that commodity in total exports.

(2) On the whole, exports of both major commodities and minor commodities 6/ were positively correlated with the growth of agricultural output; an exception was the group of manufactures among minor exports, which was correlated with industrial growth. Where better export results were associated with a higher rate of growth in both agriculture and industry, the influence of agricultural growth appeared to be the more important.

(3) Increases in domestic prices tended to deter minor, as well as total, exports. There was no association between variations in domestic price movements and performance of major commodity exports; presumably, countries isolate the latter through various devices. Countries whose ratio of export commodity prices (expressed in local currency) to domestic prices showed the greatest improvement fared the best in the export of major commodities. This finding points to the importance of exchange rates for export performance.

(4) Performance in all export categories except the non-manufacturing component of minor exports showed a positive correlation with variations in the growth of general manufacturing production. Differences in the growth of heavy industry had an influence similar to that for general manufacturing. Growth in manufacturing per se does not appear to have had an adverse effect on exports. This confirms Maizels' finding for the period 1937/38 through 1955, in his now classical work Industrial Growth and World Trade. 7/

A number of developing countries have a relatively small share in the export markets of major commodities and, as yet they have relatively small domestic markets. For these countries, an export-minded policy seems

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6/ Minor exports are those which do not bulk large as single items in a country's total exports. In total exports of the group of 29 countries, minor exports accounted for 27.6 per cent in 1950-53 and for 34.4 per cent in 1960-63. Their growth was chiefly responsible for the overall growth in exports of the countries in the sample. Between the two periods, major exports rose from $7,418 million to $7,850 million and minor exports from $2,825 million to $4,110 million. Minor exports include manufactures (except textiles).

7/ Alfred Maizels, Industrial Growth and World Trade, Cambridge, 1963.

indicated: but its success is predicated on the willingness of countries with large market shares to refrain from expanding exports. On the other hand, countries with relatively small domestic markets and sizable shares in certain world markets (for example, Ceylon, Colombia, and Malaysia) are faced with a difficult problem: external factors may make the expansion of exports relatively difficult, and domestic factors may limit the possibilities for industrialization based on a country's market. For countries in this group, the development of new exports, either of agricultural products or of manufactures, is a necessity for growth. Thailand, with its development of new agricultural exports, and Israel, with its development of both new agricultural and industrial exports, provide examples of successful strategy.

Only a few countries are lucky enough to be in the opposite category: those with relatively large domestic markets on which to base their industrialization and an export structure in which no commodity assumes a large share of its external market. Mexico is an example.

For countries whose domestic market size provides a base for diversified domestic industry and whose external market position suggests limitations on the expansion of markets for their major export commodities, emphasis on industrialization with heavy reliance on the domestic market has been an accepted strategy. This is a logical solution, with one qualification. Unless policy measures are taken to expand new exports, the industrialization process will be jeopardized because of foreign exchange constraint which will reassert itself, sooner or later. When a country is engaged in establishing heavy industry, it may pass through a period when exports lag well behind growth. During such a transitional period, inward orientation will be a rule, with heavy foreign assistance requirements. However, a systematic development of exports of manufactures at a fairly early date is also a necessity, not only in order to avoid foreign exchange strangulation but also to benefit fully from the economies of scale. The position of India and Brazil in this respect is instructive: exports of both countries have lagged for a considerable period. A shift to more outward orientation has been under way in Brazil for the past several years, with very sharp increases in exports both of manufactures and of non-traditional agricultural products. Although the recession in domestic economic activity has been a factor in stimulating growth of exports of manufactures, it is unlikely that this provides a full explanation. India is similarly now experiencing an export expansion.

Rapid and sustained growth in exports of manufactures is an indispensable condition for the acceleration of the overall export growth rate of developing countries. As indicated earlier, the international demand for many primary products rises only slowly; at the same time, the number of countries competing in markets for these products is increasing as the newly emerging nations strive to increase their capacity to import. In the face of sluggish demand growth and overcrowding of supplies, protracted periods of low prices and depressed export earnings are virtually inevitable. This dilemma can be successfully resolved if the developing countries -- primarily those which are more advanced -- cease to be excessively dependent on a narrow range of primary products as their main avenue of export expansion; this in turn requires that most of such expansion take place in the field of manufactures. The resulting reduction in the overcrowding of primary

product markets would lead to better prices and higher export earnings for all those countries which continue to be dependent on primary products for their export growth. There would thus be gains all round -- for all developing countries.

Exports of Manufactures
Salient Features

Not only have exports of manufactures from the developing countries grown rapidly, but the rate of growth has been accelerating too. Between 1955 and 1961, when world exports of manufactures increased at a rate close to 9 per cent per year, exports of manufactures, excluding base metals, of the developing countries, rose at an annual rate of about 6.5 per cent. Between 1961 and 1965, however, the relationship was reversed: for the developing countries, the annual rate of increase was 14 per cent, compared with the world rate of 10.5 per cent. Exports of manufactures from developing countries rose from $1.8 billion (less than 8 per cent of their total exports) in 1955 to $2.6 billion (9 per cent of the total) in 1961 and to $4.5 billion (12 per cent of the total) in 1965.

Nonetheless, the developing countries in 1965 still accounted for only a small fraction of total world exports of manufactures -- less than 5 per cent of the world total of $93.6 billion. This indicates the size of the market that is available. In comparison, the developing countries account for 40 per cent of world exports of primary products.

Where do the exports of manufactures from developing countries go? In 1965, some 58 per cent went to the developed countries; 37 per cent to other developing countries; and the remaining 5 per cent to the centrally planned economies. There is no evidence -- when the developing countries are taken as a group -- that their intra-trade in manufactures is expanding more rapidly than their exports to the developed countries. As a matter of fact, in the years 1957 through 1965 the opposite seems to have been true. Exports of manufactures from developing countries to developed countries rose from about $1 billion in 1957 to $2.5 billion in 1965, and those to developing countries rose from $1 billion to $1.6 billion. The slower growth of intra-trade is explained in part by the fact that the rate of increase for total imports of manufactures by developing countries was less than that for world trade in manufactures. The developing countries' aggregate imports of manufactures rose from $14 billion in 1957 to $21 billion in 1965, or by 50 per cent, while their intra-trade in manufactures increased by 60 per cent. A faster growth could have been achieved if the developing countries' exporters had been more competitive or if they had enjoyed mutual trade preferences.

For Latin America, exports of manufactures in 1965 were very low -- totaling $525 million, or some 12 per cent of exports of manufactures of all developing countries. The Latin American exports have been expanding rapidly, however, particularly during the last five years when they rose at a rate of some 16 per cent per annum -- faster than all exports of manufactures from developing countries. Most of the expansion was within Latin America itself: between 1957 and 1965, exports of manufactures to other Latin American countries quadrupled, from $54 million to $222 million, while those to the

developed countries rose by some 70 per cent. The expansion of trade in manufactures among the countries of Latin America mainly reflects the preferences of the Central American countries and the Latin American Free Trade Association (LAFTA). But why Latin American exports of manufactures to the developed countries have risen at a much slower rate than the exports of developing countries as a group remains an open question. As indicated above, aggregate exports of manufactures from developing countries to developed countries rose by 150 per cent, while those from Latin America increased by 70 per cent.

Where do the exports of manufactures originate? The largest flow is from Asia -- Hong Kong, India, and Pakistan being the main suppliers. In recent years, however, exports of other Asian countries, such as Taiwan and Korea, have shown extremely rapid growth. In Latin America, Mexico established its position as an exporter of considerable size in the early 1960s. Exports of manufactures from Brazil trebled between 1963 and 1965, and they continue to grow very rapidly; it is possible that they will exceed Mexican exports in the near future. Exports of Argentina, while substantially lower than those of Brazil and Mexico, have been expanding in the 1960s, and so have those of Colombia in recent years. In the Middle East, Iran and Israel are large exporters; Israel's exports doubled in the last four years.

Although the number of developing countries which are significant exporters of manufactures is limited, it is growing. The issue is whether the recent growth trends can be sustained or even accelerated, and whether a further spread in the geographical origin of exports can be achieved.

What is the composition of developing countries' exports of manufactures? Dominant are consumer goods, and among these textiles. But judging by the latest data available for some of the leading exporting countries, the range has been growing rapidly throughout the industrial spectrum of consumer manufactures. Chemicals account for about 12 per cent of the total. Exports of machinery and equipment have shown the fastest growth, trebling in the last eight years, compared with more than doubling for total exports of manufactures. However, capital goods account for only 10 per cent of total exports of manufactures of the developing countries. The major concentration is still on consumer goods, although diversification is increasing within that group.

Potential for Expansion

As stated above, the size of the world market in manufactures is almost $100 billion; of this total, present exports of developing countries account for $4.5 billion. This comparison, of course, greatly exaggerates the opportunities that are actually available, since the world total includes all manufactured goods, such as sophisticated machinery and equipment. But the problem can be approached differently. In a recent study, Hal Lary of the National Bureau of Economic Research attempted to identify the imports of labor-intensive manufactures into developed countries and to estimate the

developing countries' share in these imports. 8/ The underlying theory is that the developing countries have a comparative advantage in labor-intensive manufactures, despite the barriers they face; and Lary describes labor-intensive industries as those in which the total value added per employee is below the average for a similar industry in the United States. (The concept of total value added takes into account the non-wage part as representing differences in physical capital and the wage part as representing differences in skills.) Very much below the average -- i.e., intensive in less-skilled labor -- are clothing, leather and products, lumber and wood products, textile mill products, furniture, and miscellaneous manufactures. Also below the average are some rubber products, motorcycles and bicycles, small boats, glass containers, chinaware and pottery, paper and paperboard containers, and printed matter. Much of electrical machinery, while close to the average, is below it; so are metal castings and stampings, hardware, sewing machines and typewriters, surgical and medical instruments, some measuring or scientific instruments, watches and clocks, textile machinery, and miscellaneous machinery. This last group -- of marginal labor intensity -- is a candidate for rapid expansion in the future, and some country data indicate that this expansion is already under way.

Total imports of labor-intensive products into developed countries in 1964 amounted to $27.3 billion; of this, the developing countries supplied $2.4 billion. In the group of marginal labor intensity, total imports amounted to $11 billion; the developing countries supplied about $100 million. On top of this market, of course, is the market in the developing countries themselves: their imports of manufactures other than machinery and chemicals amounted to $7.5 billion in 1965. Finally, there is the market in Eastern Europe. Until now, the expansion of exports of developing countries to the Eastern Trading Area -- which has been substantial, rising from $325 million in 1953 to $1,200 million in 1960 and $2,350 million in 1965 -- has consisted mostly of primary products; but it is possible to envisage at least some expansion in manufactures as well.

The crucial question is whether the developing countries will be competitive enough to capture a growing share of the growing market. This will depend not only on import policies in the importing countries but also on the resource allocation policies in the developing countries themselves.

The fundamental advantage which developing countries have -- apart from natural resources in some cases -- is abundant labor. At least in semi-industrialized countries, the acquisition of skills has proved less formidable than is usually supposed; examples are the Latin American countries, India, Yugoslavia, and Pakistan. Labor productivity is, of course, lower; decisive here are the differences in the supply of capital per worker and the quality of management. But the crucial question is the ratio of value added to manpower costs. In the 1950s value added per worker in selected U.S. industries manufacturing products for export was between 3 and 4 times higher than the value added in respective export industries in a

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8/ Hal B. Lary, Imports of Manufacturers from Less Developed Countries, New York, 1968.

group of Latin American countries (Argentina, Chile, Colombia, Peru); but U.S. wages and salaries per worker were 4 to 6 times higher. Consequently, the ratio of value added to wages and salaries in these industries was higher in Latin American countries than in the United States. But this fundamental advantage will not be reflected in a sufficiently wide industrial spectrum to enable a massive export flow of industrial products if, at the same time, other costs are very high -- be it capital costs, costs of raw materials, or energy -- or if the exchange rate is overvalued.

Conditions for Growth

All countries which have succeeded in rapidly expanding their exports of manufactures have avoided having overvalued exchange rates; in some countries and in some periods, exchange rates may have been undervalued. This issue is of particular importance in economies suffering from inflation. If changes in the exchange rate follow changes in domestic prices with a time lag, the development of new exports, including manufactures, will suffer. A phenomenon which might be called a foreign exchange cycle develops: immediately after devaluation there is a spurt of export orders which are followed by expansion of exports several months later. As domestic prices increase, the advantage provided by the devaluation is gradually lost; in the second half of the foreign exchange cycle, exports taper off and decline. There is no possibility for developing a sustained rise in exports; manufacturers are reluctant to engage in exporting, given the risk that there may be losses when actual export deliveries take place. And of course, they are even more reluctant to build facilities specifically or predominantly designed to produce for exports.

To concentrate efforts on exports rather than to treat them as a simple by-product of the domestic market seems to be another condition for success in the export of manufactures. Hong Kong is an outstanding example of export orientation. Other examples are Israel, where exports account for about 25 per cent of the output of the textile industry; and Yugoslavia, with 30 per cent of the output of electrical machinery and equipment, 30 per cent of footwear production, and 20 per cent of the output of cotton and rayon fabrics being exported.

Under certain circumstances, the industrial structure may have a retarding effect on industrial development in general and on the export industries in particular. This retardation may occur most easily where import substitution has been carried too far behind excessive protective walls of tariffs and other restrictions. The import-substituting industries which develop do so in response to the limited domestic demand, and tend to be of small scale. The maintenance of the high costs as a result of the small scale is possible as a result of protection. Although demand may be growing at a rapid rate, the absolute increments -- which decide the size of firms -- are small. Unless a strong conscious policy is adopted, favoring the expansion of existing firms rather than the establishment of new ones, the situation tends to be perpetuated. In each industry, there may be a number of plants which are too small for effective price competition to emerge. Whatever competition there is often takes the form of increased diversification within the existing plants, and less specialization. In

such a situation, the breakthrough into the external market may become extremely difficult. Under these circumstances development of export industries will often depend on strong measures designed to bring about large changes in structure, so that new industries should be on a scale sufficient to meet international competition. This may require the removal of protective measures to provide a sanction against excessively small-scale production. It may also require government action promoting concentration. In steel tubes, kraft paper, and some heavy chemicals, investment cost per unit of output in Latin America has varied up to 100 per cent, depending on the size of the plant. Exports of automobiles and of spare parts on a considerable scale could become a realistic possibility, at least within regional arrangements, if the industries could be integrated so as to achieve economies of scale.

The fact is that the development of export industries has only rarely figured explicitly in the industrial development programs of the developing countries. It is difficult to envisage a sustained success in export growth unless such programs are formulated and implemented.

V. Concluding Observations

I should like to make three points in conclusion. The developmental environment has now undergone profound changes. On the one hand, low-income countries have income-growth targets which require rapidly growing supplies of imports. On the other hand, the drive for development is not a phenomenon restricted to a limited number of countries; it has become nearly universal. For a number of low-income countries, the expansion of primary products for exports is an obvious avenue of growth. At the same time, however, the nations which are already established producers and exporters of the same products are striving to maintain their shares of the market. The result is increased competition with declining prices of primary products and a weakening of the capacity to import in the face of rising demand for imports *pari passu* with industrialization.

Second, prospects for the future will depend on whether some intelligent way will be found for the reconciliation of different claims of primary producers -- for the establishment of guide posts for shifting market shares on a more economic basis than in the past, while promoting diversification of output in cases where restraint on production of traditional export products is necessary. Only in this way can the disastrous price competition and the commodity cycles be avoided. At the same time, improved access for primary products in the developed countries is of vital importance if the aggregate market for the developing countries is to expand faster than in the past.

Third, countries at a more advanced stage of development -- semi-industrial countries -- must expand their exports of manufactures at an even faster rate than in the past. Success in attaining this objective will depend partly on the speed with which obstacles to trade in manufactures are reduced or even preferences for developing countries are introduced, and partly on the resource allocation policies within the developing countries. It is difficult to see a solution of the foreign exchange

problem unless manufactures become a major export in semi-industrialized countries in the near future. Larger inflow of foreign capital is necessary. Studies by the World Bank Group indicate that the capacity to absorb capital has risen considerably in the developing countries. Further import substitution is possible, particularly in countries with large markets. But until industrialization is accompanied by a large flow of industrial exports, the transfer problem -- the problem of supply of foreign exchange and the problem of fluctuations -- will remain a major obstacle to growth.

file: speech BK. Avramovic

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be noticed, productive power was increasing rapidly; there must have been a sharp rise in GNP "at constant prices". But the increase in productive power does not, for a long while, get through to real consumption.

Russia in the twentieth century, like England in the nineteenth century, was initially a rich country, which could stand the strain. It is difficult to see that poorer countries, like India or some of those in Africa or South America, could stand it. In fact, whatever they say, they do not really expect to do their development autarkically.

There are two ways in which they may ease their problem by developing less "on their own". One is through trade. By importing capital goods or at least the more difficult capital goods - instead of trying to make them themselves, they may take advantage of the cost-reduction which (as we have seen) has occurred elsewhere. But if this is all,it gives no more than a limited help. For though the cost of machines has come down in terms of English or American labour, it is not so low in terms of Indian labour. For what then comes into consideration is the quantity of Indian labour which is needed to make the exports which should pay for the imported machines; and there are plenty of problems on that score.

The prospect is much better if there can be alleviation through (so-called) "movement of capital" - international lending and investment.This again comes out in my "Ricardian" model. For what caused the strain (the bad patch on my A-curve) was the failure - which I assumed, and I think justly assumed - to find a source of *increased* saving to match the heavy increase in investment, that was needed in order that the technical improvement should be carried through. Because there was no other source, the burden was thrown on to labour. The point of my argument was that if the adjustment can come in no other way, it will come in that way. Now if our single country is able to borrow abroad during its bad patch, to repay later, when it is much more capable of repaying, the difficulty is overcome. This is of course the reason why some newly settled countries-the Australias and Canadas and so on-were able to start their process of development without any comparable strain.

The obstacles to the application of that solution to the general run of what are (so pathetically) called "developing countries"are well-known; I shall not enlarge upon them. I would merely remark that there are obstacles at both ends. They are not insuperable, but they are formidable. I hope that what I have said may have cast some light on the problem with which they (and we) are confronted.

INDUSTRIALISATION OF IRĀN: THE RECORDS, THE PROBLEMS AND THE PROSPECTS*

Dragoslav Avramovic

INTRODUCTION

1. This report summarises the preliminary findings of an inquiry into the economics of Irānian industrialisation. It was prepared as a part of a broader assignment for the Industrial and Mining Development Bank of Irān: the Bank is interested in advancing further the factual and analytical bases of its project appraisals, and at a certain point this inevitably raises the general issues of industrial growth and policy. The purpose of this report is to identify such issues to the extent possible and to indicate directions of possible further evolution of policy aimed at sustained rapid industrial advance.

2. The report is preliminary, for two reasons. First, while the time available for its preparation has not been short, much of it has been spent on establishing the facts. This was not difficult - Irān is much better supplied with statistics, at least in industry, than commonly

* It would not have been possible to assemble the data and to write this analysis without the advice, wholehearted support,and assistance of the management and the staff of the Industrial and Mining Development Bank of Irān. Also, they were kind enough to comment on an earlier draft of this report. The industrial enterprises which were interviewed - borrowers from the Bank - were most generous with time and information. Finally, the senior officials of the Ministry of Economy showed active interest in the work and provided insight which was decisive in focussing the investigation on several key issues of policy. Their participation, and that of others, in the discussion of the results, kindly organised by the Faculty of Economics of the University of Tehran on July 9, 1969, not only identified the flaws in the argument and helped clarify the substance, but also indicated that most of the questions raised here are not new: the government authorities had grappled with them, in one way or another and at considerable length, in recent years. The generalisations stated in the report may be new; but they are nothing more than an attempt to set forth, in a systematic fashion, the experiences of the past and the alternatives for the future, of which the public officials and the businessmen are already aware.

believed - but it has been time-consuming; and some of the facts stated here are still open to challenge. Secondly, any generalisation in such a difficult area as industrialisation is dangerous, particularly when made without full knowledge of the many different considerations influencing the industrial structure and policy. It is for these two reasons that the content of this report is primarily in the direction of stating hypotheses and suggesting consideration of particular lines of approach rather than prescribing ready-made solutions.

3. The report is divided into three parts. The first part summarises the record of the industrial growth in the recent past and attempts to identify its major structural characteristics. The second part discusses the problems which Irān faces at the present stage of its industrialisation drive, partly as a result of its success so far in the fields of choice of industries, choice of location, industrial finance, pricing policy and the balance of payments. The third part handles the broad issues involved in the rationale and the techniques of industrial incentives and of public influence on industrial development in general. This part also makes several suggestions for further inquiry which the government authorities may wish to undertake while evolving their industrial policy.

PART I

PAST INDUSTRIAL GROWTH: DIRECTIONS, RESOURCE USE, AND ECONOMIC RETURNS

Salient Features

4. Several distinctive features have characterised Irānian industrial growth in recent years.

(i) Industrialisation has proceeded at an extremely rapid pace. It has not shown any sings of deceleration; and judging by the number and the variety of the new projects currently being considered, the rate of capital accumulation in industry and in the associated activities may even accelerate further.

(ii) Equally impressive has been the variety of the industrial complex that has cropped up. Immediately following, or even parallel with the growth of the light consumer goods manufacturing (primarily food processing, textiles, footwear and similar), considerable

investment has taken place in intermediate products industries (steel, fertilizer, other chemicals), in durable consumer goods and transport equipment, and even in capital goods (primarily in construction materials and electrical equipment). The conventionally expected time lag in moving from the light to the heavy industry has been drastically shortened, and when the projects currently being constructed are completed, in a year or two the Persian economic landscape will be substantially different from the traditional one, or even from the present one. There will be considerable production of basic materials and of investment goods, with their associated effects on the economic structure and on the balance of payments.

(iii) Almost all industrial growth has been domestic market oriented. Irān presents an almost laboratory case of import substitution - industries being started in response to already existing or anticipated demands on the internal market heretofore satisfied by imported products, such response being stimulated by generously extended incentives in the form of tariff protection or import prohibition once domestic production facilities have been established.

(iv) Both domestic and foreign private capital have participated in the industrialisation process. A domestic entrepreneurial class has sprung up, partly recruited from the ranks of the former import trade and partly from other social groups. Foreign capital has participated in many ventures started in the recent past, in association with domestic enterprise and with public and semi-public agencies. Demand for labour has increased; and while there are large masses of underemployed in the hinterland, occasional shortages of skilled and semi-skilled labour have emerged in Tehrān.

(v) Until recently, almost all industrial investment was concentrated in Tehrān, the major market. During the last few years, however, a systematic policy of geographical deconcentrations has been pursued, partly in order to alleviate urban congestion in Tehrān and partly to enable the outlying areas to share in the employment and income generated by industrialisation.

(vi) While most of the industrial growth has taken place in the private sector of the economy, the government has continued to exercise a major influence on investment and output decisions. Some projects, notably in petro-chemicals, are government-owned; and the integrated steel mill, presently under construction, is also in public ownership. Perhaps more important, the government authorities to a large extent decide on

the structure and location of output through the tariff and import policy and through licensing of new investment. An essential link in the relationships of the public and the private sectors and of the domestic economy and international capital is the rapidly growing Industrial and Mining Development Bank of Iran. It has participated in the promotion, financing and direction of almost all new industrial projects undertaken in the last few years. The government through its industrial policy, and the IMDBI through lending and equity investments, are in a position to exercise strategic leadership in industrialisation, while continuing to rely on private sources of savings and private management of individual enterprises.

5. Despite rapid industrial growth, no major imbalances in the economy as a whole have occurred so far. Agricultural output has been expanding faster than population; and while the room for advance is enormous, the progress in recent years has been faster than the long-run average. The rapid increase in income has led to increased demand, particularly for meat and meat products and for oils and fats; the response of domestic production has not been sufficiently fast and there are now growing imports of these products. On the other hand, the production of cereals has risen substantially: this refers to both rice and wheat. Expansion in cereals has occurred although the use of new high-yielding seeds is only at the beginning; as it spreads over the country, it is quite possible that Irān will have considerable quantities available for exports.

6. As indicated further below, industrialisation has been accompanied by substantial tariff protection. Surprisingly, domestic prices of manufactures have risen only moderately. Perhaps the only explanation is that profit margins in the import trade have been extremely high, so even when domestic production has been substituted for imports, now with high profits in manufacturing and under stiff protection, this has apparently just about substituted for the former monopolistic profit margins realised by the importers.[1] In any case, the domestic price level in general has risen little in recent years; and the increase that has taken place has affected both home-produced and imported goods, and both consumer manufactures and foodstuffs.[2] If anything it was foodstuffs rather than

1. See Appendix 1 for prices of selected manufactures on the domestic market in 1959 and 1968.

manufactures whose prices rose most. In the future, as the domestic production of intermediate products and of other producers goods expands under relatively high protection, it may be expected that prices of manufactures will rise under the impact of higher input costs. This seems to have been happening recently, although the picture is clouded by the fact that over-all demand has been strong, causing an upward pressure on the price level in general.

Key Indicators

7. Table I sets forth one of the key indicators of the industrial structure: the percentage share of imported inputs in the value of output. The lower the number shown, the greater the proportion of total output that is attributable to domestic factors of production, i.e., the larger the value added (the inverse of the import dependence percentage is the domestic dependence). This will happen when either the industy is labour intensive, so that a large part of the total cost (and of the sales price) is accounted for by the wage bill (e.g. telephone equipment); or when the inputs of raw materials and components are primarily of domestic origin (e.g. cement) or both (e.g. textiles).

8. The industries selected are those which have been established in the recent past; in some cases, projects under construction with their planned cost composition are shown. (Such cases are identified in the Table). The list of products is fairly representative of both the present industrial structure of Irān and of its recent growth: capital accumulation in industry has proceeded so rapidly in recent years that the additions to the capital stock have probably equalled the depreciated value of the stock existing as of the early 1960's.

9. It would have been desirable to list in Table 1, in addition to the value-added indicator, another indicator by product: that is the percentage excess of the domestic price (or cost) over the CIF long-run import price. This would have shown the inter-product differences in resource use, and also, when averaged out, the extent to which the prices

→10.2 per cent and the cost of living by 18.9 per cent. In the wholesale index, prices of home-produced and consumed goods rose by 11.6 per cent imported goods by 13.4 per cent, exported goods by 2.7 per cent, and foods by 15.9 per cent (International Monetary Fund, *Consultations Report on Irān*, January 1969).

Table 1

Irānian Industry: Import Dependence

	Share of imported inputs in sales value[a]
Light consumer goods	
Sugar	2 per cent
Meat Packing	10
Cotton Textiles	10
Footwear	10-20
Canned Fruits and Vegetables	10-20
Woollen Textiles	40
Vegetable Oils	50
Pharmaceuticals	60
Durable consumer goods	
Electric Fans[b]	26
Radios	37-50
Space Heaters	40
Refrigerators	40 (understated?)
Air Coolers	60
TV Sets	60
Transport equipment	
Diesel Engines[b]	33-43
Trucks	48
Buses	n.a. (probably as trucks)
Passenger Cars	50
Tires	50
Intermediate products	
DDB (Dodecil Benzane)[b]	10
PVC[b]	10
Caustic Soda	10
Glass (Sheet)[b]	10
Paper	25
Paints	45
Synthetic Fibres	n.a. (above 50?)
Rolled Steel	60
Capital Goods	
Cement	20
Carbon Steel and Stainless Blades	20
Telephone Receivers	20
Electric Metres[b]	20
Telephone Exchanges[b]	20
Steel Wire, Nails and Screws	30 (?)
Pumps	40
Transformers	45
Cables	65-90
Electric Switchgear	80

Table I (continued)

a. Imported components include raw materials, semi-finished products and spare parts. Both direct and indirect import content are included. (The indirect content being defined as imported materials bought on the home market rather than directly imported by the user).
b. Project under construction; planned values.

Notes:

(1) Question mark indicates that there are other conflicting estimates; or the data are a guess; or the data are unreliable; or the data do not seem plausible.

(2) In some cases only one plant producing a particular product was interviewed; as a result, the data may not be representative of the situation of the industry. This qualification does not hold when the product is produced by one plant only: there are a number of such cases. Furthermore, where more than one plant was interviewed, the cost composition and the cost levels appeared remarkably similar.

(3) There is a methodological point relating to the proportion of imported inputs. Since they are valued at domestic prices, i.e. they include the customs duty, an upward bias in the proportion is introduced. On the other hand, the sales price itself is a result in part of the customs duty applicable to the final product, and the duty rate here is normally higher than that on imported inputs. This introduces a downward bias in the import coefficient. The net effect could be determined only if both the inputs and the outputs were valued at CIF imports prices and the proportions so derived were compared with the proportions set forth in Table 1. These proportions are likely to differ in particular cases; but it is doubtful if the over-all picture would be significantly different.

Source: Interviews with the industrial plants and the material in the IMDBI files.

(or costs) of domestic production are higher, over-all, than foreign prices and costs. The available data were collected, but their imperfection limits their explicit use, product by product, at the present time. In some cases, the domestic price data conflict; in some the import prices differ greatly, depending on the origin; and generally there is uncertainty as to what is the long-run import price with respect to the latter point, in many cases it was found out that the import price net of freight, etc. (i.e., the export price in the exporting country) was considerably lower than the price in the domestic market of the same exporting country, mostly about 25 per cent, but in some cases up to 50 per cent indicating a fairly widespread use of marginal cost pricing by the exporters. This, of course, is difficult to take as the long-run import price. Some broad generalisations concerning price and cost relations can still be made, however, as indicated below.

Price Relations

10. Domestic industry charges higher prices, at the prevailing exchange rate, than the CIF cost of imported products (i.e. import price without duty), in the large majority of cases. The significant industries where domestic prices are equal to import prices or lower, are footwear, cement, and some processed foodstuffs. Some of these products are exported on a significant scale (e.g., shoes). There are also other industries whose prices are low in relation to import prices, e.g., pharmaceuticals, switchgear, cables), but these essentially consist of simple operations - packaging, assembly and simple processing of imported inputs - with little value added.

11. The higher prices of domestically produced goods in relation to import prices for comparable products can be a result of three factors: first, domestic costs of production are higher, (e.g., synthetic fibres, glass) due to temporary or longer-lasting causes; second, the remuneration required to attract capital to industrial production may be higher than in the developed countries where risks are lower; and third, domestic products are taxed much more than the same products moving in international trade, by sales taxes, excises and similar, either directly (e.g., sugar) or indirectly - through customs duties payable on imported components (e.g., automobiles, refrigerators) and through sales taxes payable on domestic components. In most cases, it is not one, but two or more factors at

work.

12. A simple ranking of the industries according to the level of the excess of domestic prices over CIF import prices yields a median value of 25-33 per cent.[3] This average is influenced by the fact that some of the old established industries are below the 33 per cent mark (food canning,cotton textiles). At the margin, i.e., for the industries recently established or currently being considered, the excess domestic "cost" is unlikely to be below 33-40 per cent. Some industry executives seem to feel that an across-the board tariff protection of 33 per cent would be sufficient and appropriate, and also, that a similar order of magnitude of export subsidies would result in a major expansion of non-traditional exports. But these hypotheses (rather guesses) would have to be seriously verified before any particular benchmark number is used for measuring "efficiency".

(b) Value Added Proportions

13. The domestic industrial sturcture clearly splits up into resource-based activities and the activities based on imported materials.In the first group are food processing, cotton textiles, some chemicals, construction materials, telecommunications equipment and some electrical goods. The second group consists of all appliances, automotive equipment, steel products and capital goods which are material-intensive,and synthetic fibres. At the present moment, of the 37 product lines, in less than half (16 products) is the share of imported inputs less than 33 per cent i.e., only in these cases the domestic value added exceeds two-thirds of the total value of output. As the domestic industry producing intermediate goods expands, the proportion of industries using domestic materials will also increase, and so will the domestic value added. This refers specifically to the industries which make a heavy use of steel, copper,vegetable oilseeds and wool.

National Economic Profitability

14. From the national economic view point, those industries are most profitable which yield highest value added at lowest resource cost.

3. The range is between 0 and 200 per cent.

In terms of the indicators discussed earlier, this means industries in which the share of imported inputs is lowest and whose prices are least above the world market prices. The complication here is that domestic prices reflect not only production (resource) costs, but also differential custom duty rates of a revenue nature: such indirect fiscal changes are transfer costs, which just happen to be collected, for reasons of fiscal convenience, by charging the consumption of particular products. This complication prevents us from drawing too hard conclusions from the data. On the other hand, however, high duties are charged mostly on the imports of appliances and transport equipment and their components; given the economies of scale which have to be satisfied in this sub-sector for low-cost production, and given the low prices of these products in international trade due to severe competition of the major suppliers, it is likely that even in the absence of heavy fiscal charges, Irānian production would remain high-cost for some time, unless a large volume of these goods can be produced, i.e., both for the export and the home markets.

15. An attempt is made in Table II to cross-classify the industries using both the criterion of value added and the criterion of relative costs. The industries in the top quarter of the Table are the "best". The contribution of particular industries to national economic growth, per unit of scarce resources used, diminishes as we move down the Table.

16. It is not the purpose of Table 2 to serve as any definitive guide to the economics of Irānian industry - for this, more work is needed on the basic information, and also, the subjective judgments used in putting border-line cases into particular boxes would have to be refined. The primary purpose of the table is to suggest that, from a methodological viewpoint, this is presumably the way in which the decisions to lend, or to grant tariff protection, or to stimulate a particular industry in other ways, may usefully be considered. Namely, resources ought to be concentrated in those sectors and sub-sectors of the economy where the national economic returns will be highest; and they will be highest if the employment generated in the industry itself and in the activities supplying the materials to it (Hirschman's "backward linkages"[4]) and using the product ("forward linkages"), is large, i.e., if value added is large; and if costs of production are low in relation to costs of producing alternative

4. A.O. Hirschman, *The Strategy of Economic Development*. (New Haven: Yale University Press, 1958).

Table 2

Iranian Industry: National Economic Profitability Rating

A. High Value Added and Relatively Low Prices	
Cotton Textiles	DDB (?)
Footwear	Cement
Canned Fruits and Vegetables	Other Construction Materials
Meat Packing	Electric Metres
	Paper (?)
	Telephone Receivers
B. Low Value Added and Relatively Low Prices	
Woollen Textiles (?)	Tires
Vegetable Oils	Pumps
Pharmaceuticals	Transformers
Diesel Engines (?)	Cables
Buses (?)	Electric Switchgear
	Rolled Steel (?)
	Paints
C. High Value Added and Relatively High Prices	
Sugar[a]	Telephone Exchanges
PVC[b]	Steel Wire, Nails&Screws (?)
Caustic Soda[b]	Radios (?)
Glass[c]	Space Heaters (?)
	Electric Fans
D. Low Value Added and Relatively High Prices	
Synthetic Fibres	Trucks (?)
Refrigerators	Passenger Cars
Air Coolers	Radios (?)
TV Sets	Space Heaters (?)
	Rolled Steel (?)

a. High price due to the high price paid for agricultural inputs and to high sales tax.
b. High price partly due to offset the low price charged for DDB; also, caustic soda partly sold at the world market price to the Oil Consortium, which would reduce the average price charged and perhaps change the classification.
c. Considered to be a special temporary situation.

Notes:

(1) The question marks indicate difficulty of classification to some doubt concerning the accuracy of basic data.

(2) Classification of prices is in relation to import prices CIF, net of duty. "Relatively Low" prices are generally those where the excess of the domestic price over the import CIF price is below 33 per cent. "Relatively High" prices, where the excess

products with the same resources, all measured in terms of international prices. This is because, within limits, the country always has a choice of producing a good X or importing it in exchange for a good Y, if the domestic costs of production of Y are lower than those of X.

17. Any classification of the industries and of the other activities according to the criteria set forth above, or according to similar criteria, should be read in the dynamic context and interpreted accordingly, (see para.13 above). If woollen textiles are now classified in Group B -- low value added and low resource cost -- they presumably should not remain there, but move into Group A -- high value added and low resource cost. One of the purposes of national policy could be to introduce new varieties of raw wool and to carry out a radical modernisation of the collection and preparation of domestically produced wool, so that the present heavy imports of raw wool can be reduced and eventually eliminated, if this can be done economically. The same argument holds with respect to vegetable oils production: it is presumably possible to produce at low cost all oilseeds that are needed for domestic vegetable oil consumption and for the domestic use of oilcake as an input into the domestic meat industry. (At the present time cotton-seed cake is exported while growing quantities of meat are imported; and domestic vegetable oil refiners import crude vegetable oil instead of importing oilseeds or even better, using domestically produced oilseeds). Also, in view of the available resource there is no reason why products such as PVC, synthetic fibres, and glass should not be low cost. In steel products, which are now also classified in the low value added group, the situation will change as the projects presently under way or considered are completed; the key question here will be the price charged to the users in view of the possibility that high internal transport costs may offset the advantages of high-volume production.

18. In short, one of the major purposes of a systematic and

→ is above 33 per cent.

(3) Classification of value added is in relation to dependence on imported inputs. "High Value Added" are generally those industries where the dependence on imported inputs is below 33 per cent of the value of output (sales price); "Low Value Added", where the dependence is above 33 per cent.

comparative analysis of the industry according to the value added and the resource cost criteria, would be to provide a quantitative basis for a strategy of growth - industrial growth and integrated commodity growth - industry, agriculture, and mining. These criteria are already used by the authorities in formulating industrial policy and in decision-making on the new industries. A possible evolution of this approach is in the direction of making the analysis systematic, comparative, explicit and long-range.

PART II
FUTURE INDUSTRIAL GROWTH: PROBLEMS AND CHOICES

19. Five main problem areas can be identified at the present time: the choice of industries to promote, the choice of industrial location, the provision of industrial finance, co-operative arrangements with foreign capital, and the balance of payments effect of industrial growth. Specific issues have already arisen in each of these problem areas; and they will multiply during the 1970's.

Which Industries?

20. In its industrial policy, Irān will be facing the following choice with increasing frequency:promoting industries catering primarily to the domestic market, irrespective of whether the inputs can be supplied domestically at a reasonable cost or have to be imported and/or produced domestically at high cost; or promoting industries which are based on the utilisation of domestic resources and are low cost, irrespective, in this case, of whether the final product is sold on the domestic market or predominantly exported.

21. In actual practice, the choices never appear so sharp when decisions on particular projects are made: both the investment lender and the tariff commission will always try to promote industries which have some resource base. The problem, however, is that these specific decisions have to be made within the over-all framework of prices and costs, as determined by the general policies on tariffs, subsidies, taxes and other government measures affecting industry; and it is this framework that primarily determines whether, over-all, industrial investment and

growth are primarily directed to meeting the demands of the domestic market even if this implies high real costs, or whether they are primarily based on the availability of resources and of factors of production which can be used efficiently and at low cost.

22. The choice between these two strategies does not arise in the first phase of industrialisation - the phase which Irān has just about completed. In this phase, import substitution is the rule, covering light consumer goods industries - food processing, textiles,footwear,simple capital goods,and construction materials.In most of these cases, the economies of scale are not very significant, so that the costs can be kept relatively low even at the low output volumes demanded by the home market. Also, in most cases, the raw materials are available domestically, at least in part; therefore, these industries, while catering to the home market, are also to a considerable extent resource-based. The choice between the two strategies arises as the next phase of industrialisation starts and proceeds: in this phase, it is the rising demand for intermediate products, appliances, transport equipment and capital goods, which has to be met. Hence, it is in this phase that the decisions have to be made whether and which goods to produce at home, and which ones to import in exchange for exports, and for which exports.

23. The dilemma is not easy. Most intermediate products, appliances and transport equipment, and some capital goods, call for large output volumes if the costs are to be kept relatively low; while the development of industries for exports represents a new venture, where high standards of quality, delivery schedules, finance and cost competitiveness have to be met. The risks of failure are substantial in either case.

(a) Experience of Other Developing Countries

24. Most developing countries during the last two decades have selected the first strategy - a continuing import substitution based on domestic demand. Some have done so because their resources have been poor; but in most cases, a number of complex factors have been at work.

25. There is nothing wrong with a continuing emphasis on industrial growth based on meeting domestic demand, provided:

(a) The efficiency criteria as dictated by the minimum-size plant requirements are reasonably satisfied;

(b) the employment effects, direct and indirect, are substantial

and in line with the over-all needs of the country;

(c) there exist in the country export oriented low-cost primary product activities which, despite the resource concentration on industry, continuously yield a sufficiently rapid growth of earnings of foreign exchange which can be used to meet an import bill which increases rapidly under the impact of rising industrial demand for intermediate products, components and capital goods.

26. The fact is that in most developing countries these conditions have not been met, basically for three reasons.[5] First, as import substitution has moved forward from light consumer goods to intermediate products, appliances, transport equipment and capital goods, the efficiency has fallen off and costs have risen, partly because of the greater technical complexity and intra-plant scheduling requirements of these branches, and partly because of low-volume output. Secondly, the employment effects of this pattern of growth have been weak. Modern industrial plants in intermediate products and in some capital goods employ little direct labour, while the employment generation in the supplying and the using industries has also been relatively moderate, due to the insufficiency of resources for their development, resources which have been locked up in a limited number of large capital-intensive plants. Thirdly, and most important, the industrialisation process has come up against the balance of payments constraint. A heavy emphasis on import substitution based on high tariff protection, combined with other factors has made it difficult to develop competitive exports of industrial goods to any substantial extent; while at the same time, the continuing industrial growth and the associated rapid urbanisation have given rise to virtually insatiable import demand. Since most traditional export products and some key light industry goods (textiles, many of food processed products) have encountered serious marketing problems, either because of inherent limitations on world demand for primary goods or because of trade obstacles, the net effect has been that the rising demand for imported industrial inputs

5. See the study recently prepared by the OECD Development Centre, *Industry and Trade in Seven Developing Countries*, under the direction of I.M.D. Little, Oxford University and T. Scitovsky, University of California (now in print). The study is supported by specific country analyses (Brazil, Mexico, Argentina, Philippines, Taiwan, India and Pakistan) and by specific analyses of particular enterprises in selected fields. One outcome of this effort is the recently published *Manual of Industrial Project Analysis*, Volumes I and II, OECD, 1969.

could not be met. As a consequence, a part of the already installed industrial capacity could not be used; and under-utilisation of capacity, in turn, has led to a reduction in new investment, both in the private and the public sectors. The problem of insufficient capacity utilisation and how the situation can be improved has by now become one of the central problems in the economic policy of developing countries.[6]

(b) The Situation and Prospects of Irān

27. Irān is better placed than most other developing countries to avoid this chain of events. It has an extraordinary range of natural resources which make it independent of foreign supplies of critical materials. The largest single drain on foreign exchange in developing countries has normally been the imports of petroleum and petroleum products. The next largest drain has been imports of non-ferrous metals, followed by the imports of chemicals. As a major producer of petroleum and as a potential producer of petroleum-based chemicals, Irān could cut substantially on imports demand; and as a potential producer of copper, it could meet its domestic demand and still add to its exports. Finally, the variety of climate and of soils makes Irān virtually self-sufficient in food- stuffs and agricultural raw materials. Cereals, temperate zone fruits and vegetables, and some tropical foods and cotton are already produced on a significant scale, mainly for the home market, but also for exports; while the possibilities of expanding the domestic production of meat, wool and vegetable oilseeds should be substantial.

28. One way to realise this potential is for Irān to consider, in her co-operative arrangements with foreign partners, requesting the inclusion of new Irānian products in their international sales network. Also, in her trade agreements with countries from which Irān imports heavily, she may insist that these countries accept growing quantities of the new Irānian exports,a practice which has already been started.

29. The availability of natural resources is no guarantee that they will be exploited: they are a necessary but not a sufficient condition for growth. Whether they will be exploited or not, at what speed and with what efficiency, depends on the priority they are accorded in government policy, and perhaps above all, on their profitability as determined by

6. See UNCTAD, *Country Studies on Insufficient Capacity Utilization*, Geneva, 1968; and UNIDO, *Conference on Capacity Utilization*, Rio De Janeiro, 1969.

the prices they command and by the costs of exploitation as influenced by the organisation of production.

30. The need to develop resource-based industries does not mean that further import substitution should be stopped. The only thing it means is that resource-based industries ought perhaps to be given the same chance to develop as the import-substitution activities. At the present time, the chances are not equal. Import substitution enjoys high protection; the duties are particularly high on finished goods,higher than on raw materials and on intermediate products, although a series of changes in the tariff structure in favour of this latter group of products is now under way. As costs of supplies, now domestically produced, will be higher than the imports, the competitive position of the activities utilising such supplies is weakened. For example, the production of footwear now has to stand a higher cost of thread and chemicals since they are domestically produced under protection,and its export competitiveness is reduced since there is no possibility of obtaining a drawback of the higher charges. (When these products were imported, under duty, the industry could obtain a drawback in proportion to exports). The production of canned fruit cannot be fully competitive despite excellent quality and ample supplies of the basic raw material, because the price paid for sugar is twice to three times higher than the price paid by foreign competitors. The net effect is that the industries which have a comparative advantage cannot realise it because the incentive system operates in one direction only: it raises the prices and profitability of import substitutes, without a similar incentive, or at least a corresponding offset, in favour of other industries.

31. In a policy aimed at a maximum utilisation of the domestic resource base, special attention should be paid to the domestic processing of the available raw materials. For example, if the copper deposits are exploited, the promotion of the domestic copper using industries would command priority. One of the most encouraging features of the recent industrial advance has been the establishment of several modern plants in the electrical and telecommunications field, which appear efficient and ready for further expansion. If the development of copper production is linked with a programme of growth in the domestic copper-using industries, producing both for the home market and for exports, and benefiting from steady and relatively favourably priced raw material, the benefits to the

economy would be maximised through the generation of additional employment, the associated value added, and the higher-valued exports and technical specialisation in finished products commanding scarcity prices in the world market.

32. Perhaps the basic advantage of a policy in which resource-based industries enjoy the same priority as industries oriented exclusively to meeting the demand of the domestic market, is that it would probably provide productive and rising employment opportunities not only to the urban but also to the rural areas of Irān. It is in the rural hinterland where the heart of the development problem lies,where most of the population is concentrated,and where incomes are lowest. The accelerated growth of resource-based industries would call for increasing supplies of basic agricultural raw materials and food stuffs at a faster rate and over a wider range than would be the case with the other industries, with their heavier inputs of imported materials and of urban labour engaged in assembly operations.

33. Three additional points should be made on this subject. First, the emphasis already given in recent years to the development of petrochemicals as a resource-based industry should result in an improvement of the export position. Secondly, the promotion of resource-based industries by itself is not sufficient: if the projects are poor in technical design, or if their planned output volume is too small, or if capital cost overruns are very heavy, the results will be adverse irrespective of how much the industry concerned has comparative advantage in principle. Thirdly, whether in any particular period the emphasis will be placed on import substituting projects or on those producing for exports, and how much special incentive will be needed in either case (in the form of protection or export subsidy), depends critically on the availability of alternative projects which are ready for execution and which offer better returns. It is of limited usefulness to argue that a certain group of projects should not be undertaken because their costs of production are high in relation to CIF import prices, if at the same time an alternative set of projects is not offered where costs are low in relation to import prices.

What Location?

34. In their recent development policy, the government authorities

have emphasised three major points:

(i) the need to halt, for the time being, further industrial concentration in Tehrān;

(ii) the need to spread industrial investment all over the country;

(iii) the need to improve and expand further surface transport (rail and railroad).

35. There cannot be a serious dispute about the desirability of deconcentration away from Tehrān. Also, there cannot be a serious argument about the need to improve the transport facilities. The open questions concern the choice of location in the hinterland, and the choice of the modes of transport to emphasise.

36. There are three major aspects to these issues. The first concerns the structure of future growth as discussed in the preceding section. If the emphasis on industrialisation and on an over-all growth policy is partly shifted in the direction of resource-based and export industries, certain locational decisions inevitably follow. Non-petroleum exports have shown a significant upward trend in recent years (about 10 per cent), although they still account for a relatively small proportion of the total (15 per cent of the value of imports). Within this, the most remarkable has been the expansion of non-oil exports to the other countries in the Persian Gulf: they have risen from $5 million to $30 million in five years. It is in this area that Irān has the potential trade advantage, compared to other suppliers: in transport costs where they are significant in relation to FOB values, and in the closeness of cultural and other relations; and the Persian Gulf is an uniquely attractive trading area, with enormous and rapidly rising purchasing power, most of which has to be spent on imports. If Irān adopts as one of its major economic policy objectives the expansion of exports, which would logically imply exports to the Persian Gulf, this would have definitive locational implications, for agricultural activities,food processing industries,construction materials industries, for production of durable consumer goods and of capital goods, as well as for the associated transport needs, surface, sea, and air.

37. Similarly, Irān will sooner or later have to decide on the specific nature of its trade relations with the U.S.S.R. The obvious region which has a transport cost advantage is the Caspian littoral. In view of

the climate, subtropical and tropical crops can presumably be grown, and processing plants established. The products would have an excellent market in the U.S.S.R. and if shipped through the Caspian Sea, they could reach the industrial heartland of Central and Northern Russia at an extremely low transport cost compared to that of all other suppliers. Any such export strategy would call for locational decisions, both with respect to agriculture and to industry. The precondition, of course, is the stability of the trade relations.

38. The second aspect concerns the location of industries operating primarily for the home market. At the present time, there are reportedly cases where instead of one plant of economic size, several smaller plants, each undersized, have been considered for the same product in different parts of the country in order to assure an equitable regional distribution of investment. The same objective could be attained if, instead of splitting up one investment, a systematic policy of concentrating specific industries in the different parts of the country were pursued, taking into account the comparative advantages of each particular regional location and of the differential transport costs. The advantage of concentrating particular industrial branches in predetermined carefully selected locations are obvious: the use of common research and development facilities, the benefits of a trained labour force, the development of specialised schools, the ease of communications within the industrial complex, the adaptation and the development of the supplier's industries, etc.

39. The possible pursuit of a systematic locational policy is facilitated by the fact that a certain locational pattern is already emerging, with the different major cities of Irān becoming centres of specific lines of activity (textiles in Tehrān, engineering products in Tabriz, chemicals and steel products in Ābādān-Ahwāz). A study of an optimal locational pattern could provide a basis for a long-range policy by the government in issuing licenses and by the development banks in granting investment loans.

40. The third aspect concerns the choice of the modes of transport. As one travels through the vast expanses of Irān, one is reminded of the sea and its islands: economic activity is concentrated in what amounts to oases separated by vast distances, each one almost self-sufficient in food supply. At least some of the roads seem quite lightly used.

41. The existing roads will have to be maintained and improved as

the traffic justifies, and new roads will also have to be built as the needs develop. The question does arise, however, as to whether or not internal air traffic should not play a substantially larger role than at present in meeting traffic needs. Already, an industrial plant located deeply in the interior prefers the supply of spare parts and even some components to be delivered by air: it is much faster and on balance cheaper. In any study of future transport investment needs and of transport policy, the competitive position of the air transport in relation to the other modes would have to be closely examined. If a significant expansion of air transport is justified, this may have further implications for the establishment of repair and maintenance facilities in Irān, which may, in turn, serve not only its needs but also the needs of the other countries in the Persian Gulf which are also likely to be increasingly dependent on air traffic in view of the distances to be covered. The repair and maintenance facilities, of course, could be the nucleus of the production of components in the long-run future.

Industrial Finance

42. So far, it does not appear that the availability of finance has been a serious constraint on industrial growth. The funds needed for fixed capital formation have come from oil-revenues, external loans and self-generation of profits. The funds needed for working capital appear to have come mostly from commercial banks.

43. As the industrial structure changes in the direction of intermediate products and capital goods, the requirements both for fixed capital and for working capital finance are likely to increase. The new demands on resources, in the form of needs for medium-term working capital (sales) finance have already emerged, both in consumer durables (e.g.,automobiles) and in capital goods (e.g., cables, transformers).

44. The growing sales of consumer durables require installment credit finance, spread over a few years; and the sale of capital goods requires sales finance spread even over a longer period.Unless the domestic financial system is given the means to provide such facilities from the domestically generated and from the externaly borrowed funds, domestic industry will experience difficulties in competition with foreign suppliers in offering financial terms. This industry, being still infant, already operates at certain inevitable disadvantages; it would be awkward if, in addition, there occured difficulties due to the lack of sound sales finance. Such finance should be available for both domestic and export trade.

45. In considering the establishment of a special facility for medium term sales finance, two things should be born in mind. First, in the absence of such a facility, domestic producers will either lose sales to foreign suppliers although they may be competitive in price and in quality, or they would have to resort to borrowing abroad, at terms more disadvantageous than the terms at which a central facility would normally be able to borrow. This is a strong argument in favour of its establishment. A strong argument against it is that it may be misused to make possible sales, on easy credit, of domestically produced durable goods which otherwise could not be sold, because of price or quality, in competition with foreign goods. It is the unfortunate experience of some developing countries, in the field of passenger automobiles, refrigerators, air conditioners, etc., that inefficient domestic industry has been kept alive through installment credit extension, at the expense of these countries' higher priority needs. Irān may wish to benefit from their experience. It should extend to domestic manufacturers sales finance on the same terms extended by foreign agencies to their domestic producers for exports: but it should extend it only to industries and firms which can compete, price-wise and quality-wise, with foreign suppliers,within a clearly defined and stable protection limit.

Monopolistic Pricing

46. From the multiplicity of close relations which Irān has with foreign private capital, there is one aspect which should be singled out for the purposes of the present analysis: the licensing policy.The government authorities appear concerned that individual firms, after obtaining protection or after the import ban has been introduced, might exploit the situation of being a *de facto* monopolistic seller. In order to avoid this possibility, the practice seemed to have been to issue licenses to several firms for almost every product. The number of licenses issued can in some cases become very large (e.g., TV sets).

47. This policy does not have any adverse effects if the market is

sufficiently large, so that the unit costs of production do not rise. If these conditions do not hold - and they do not in most products which are now considered for domestic production - the effect is a proliferation of production lines, and aggravation of the problems of scale and low-volume output at relatively high cost. High prices would then prevail, this time as a result of high cost, i.e., of excess resource use, rather than of monopolistic practices.

48. An alternative to this situation would be to give an exclusive license for a certain period to a single firm or to two firms, after competitive bidding. Imports would continue to be permitted to enter freely, after paying a pre-determined duty. In this way the market would not be split up among several production units and production costs could therefore be lower; while the monopolistic situation would be mitigated throug imports which would set an effective ceiling on the price which the producers could charge.

49. In considering this issue it should be born in mind that the existence of several firms protected by import prohibition is no guarantee that *de facto* monopolistic selling practices would be avoided. This applies equally to both domestically owned and foreign owned firms. There is probably no effective way of preventing undue price increases except by letting imports come in after duty; and if this is correct, it may be best to combine it with a licensing system which promises to lead to low costs per unit of output.

Balance of Payments Effects

50. It was stated in Part I that much of the newly established industrial plant is heavily dependent on imported materials and components. The aggregate effect of this import dependence has been that in the five years 1342-1346 (1964-1968), imports have risen at almost 17 per cent per annum; and within this, the imports of intermediate products have increased at close to 19 per cent per annum. This rate of expansion has been faster than the rate of industrial growth and faster than the past and the likely future growth of petroleum exports and of other traditional exports. Should these trends continue, Irān would inevitably encounter external financial difficulties which would tend to slow down the rates both of industrial growth and overall growth.

51. In Part II it was mentioned that non-petroleum exports have shown a significant increase in recent years, almost 10 per cent per annum mainly due to the new export production. As additional products enter the production spectrum, exports will tend to expand further;and the existing export items will also tend to expand as surplus capacity occasionally appears. But it is highly unlikely that the rate of expansion will be anywhere near the growth in demand for imports under the present system of prices and costs. The costs in domestic manufacturing will inevitably creep up under the impact of protection which will now increasingly cover raw materials and intermediate products.Moreover there is no way in which the production for exports can offset these cost increases, as the system of incentives now operates (see page 18, para. 32). It will not be easy for domestic producers to penetrate the highly competitive export market in any case and this job will become doubly difficult with the prices of their inputs on the rise.

52. It was also mentioned in Chapter II that the natural market where Irānians exports, agricultural and industrial,command transport and other advantages, is the area of the Persian Gulf. The exact structure of this market and its changes over time are not precisely known but the Irānian authorities have made several surveys of the import demand of particular territories in the area. At present a comprehensive statistical study of this entire market based on the exporting countries data is under way. This should provide information not only about the present import demand and the demand trends for different products of interest to Irān, but will also show whose competition will have to be met. Such a survey should help in the planning of an export strategy for Irān; and it may also help a joint co-operative strategy for Irān,Pakistan and Western India, if it were to be formulated.

53. An export expansion in the direction of the Persian Gulf would be facilitated by investments jointly owned by Irānian nationals and nationals of the Gulf countries concerned. It could even be envisaged that certain facilities, e.g., packaging, assembly, etc., be located in the prospective importing countries, while basic facilities would be mostly in Irān. It is also possible to contemplate the possibility of attracting some of the major international companies to participate in such an expansion.

54. The question does arise, however, as to whether the potential exports will materialise on a large scale without sufficient export incentives. This subject is a part of the over-all consideration of cost-price relationships in the Irānian industry and economy in general. The concluding part of his paper discusses this problem.

PART III
PRICES, COSTS AND RESOURCE ALLOCATION

A Digression: Employment, Efficiency and Trade

55. One of the major problems facing Irān today concerns prices, costs and their relationship. The way in which this problem is resolved will to a large extent determine the direction of growth, the external financial position of the country and ultimately the rate of growth itself.

56. It was stated in Chapter I that most of the recent industrial advance has taken place under relatively high protection. The experience of Irān in this respect is not unique: most developing countries undergoing industrialisation during the last two decades have resorted to high protection.

57. There is no satisfactory theory at the present time to explain the basic reasons for this phenomenon. A hypothesis can be put forward, however, dealing with the employment, resource allocation and trade effects of a system without protection; and then, working back,another hypothesis can be formulated concerning the rationale of protection as an incentive device

58. Take the case of a developing country heavily dependent on a primary product for exports, without any industry. It imports all the industrial goods it consumes and operates its economy under a completely free trade regime. Under these conditions, it is logical to suppose that the production of the primary product for exports is the most efficient of all its potential lines of production: this is the activity which has developed "naturally", without any intervention, because the country was cheaper in this activity than in any other; and it was also competitive in the world market.

59. Now, if our imaginary country could employ all its available

labour in producing the primary product for exports; if it could continuously raise productivity per man hour; and if it could sell the additional production without a reduction in the selling price - the country would enjoy full employment at steadily rising real wages. In short, it would specialise in producing a product in which it is most efficient. There would be no need for either industrialisation or protection: the country would get rich just by modernising its primary export activity.

60. It is these conditions which seem to have been met in the "countries of recent settlement" of Folke Hilgerdt in the nineteenth century in Canada, Australia, New Zealand, Argentina, U.S.[7] These countries produced with high efficiency growing quantities of agricultural products for the rapidly rising market in Europe which at that time was not protecting its agriculture; and for some time, they could employ all their labour at rising real wages in these export-based activities. Today, these conditions are met in the case of small countries producing petroleum: world petroleum demand rises relatively rapidly; their share in the total market is not very large so that even if their production expands at a faster rate than world consumption, the prices will not fall; and their population is small, so that all their labour can be employed in oil production and in oil-connected activities at rising real wages. Kuwait and other countries with a small population in the Persian Gulf are in this situation. For the time being, they need neither industrialisation nor protection, except as an insurance against possible disturbances in the petroleum market or against technological change which could cause the demise of oil as the most sought-after commodity.

61. The problem begins when the conditions stated in paras. 60 and 61 are not met. If a country produces a product which is not in strong demand in the world market; if its share of the market is already so large that any further expansion would reduce the sales revenue due to declining prices;or if there are restrictions on export expansion due to trade and other obstacles abroad; if the country has large population; and if, as a result, only a fraction of the labour force can be employed in the primary product export activity - an entirely new situation is faced. Under these conditions, the economy may face a prolonged, perhaps even indefinite, period of under-employment and economic stagnation.The only way

7. League of Nations, *Industrialization and Foreign Trade*,(Geneva, 1945.)

in which this circle can be broken is to start new activities, in addition to the traditional primary export production, to absorb under-employed labour at remunerative wages.

62. If the efficiency of resource use in non-traditional fields were as high as in the primary export product, full productive employment would be achieved. But the efficiency is not the same: had it been so, such new activities would have already developed. For as long as the basic framework of price relations with the outside world is determined by the efficiency level (i.e. the cost level) in the most efficient activity, all other activities are stunted, since they are not competitive with imports. And the larger the difference between the efficiency level in the primary export activity and the efficiency level in other activities, the more protracted and severe the underemployment in the rest of the economy. From a national economic viewpoint, it would pay to employ all the labour for as long as the goods produced cover costs - the going wage rate and the going rate of return on capital; but this cannot be achieved under a regime of free imports which are priced on the basis of the ratio of foreign costs to domestic costs in the most efficient industry.

63. Whatever may be the specific factors which in any particular case lead to a decision to grant high protection, it seems that the fundamental common cause, in Irān and elsewhere, should be sought in the difference in the efficiency levels between the highly developed, experienced and resource-based primary export activity which however cannot employ all labour, and the other activities which are inferior, new and untried but have a great employment potential. The larger the difference in efficiency, the greater the incentives needed to achieve full employment.

The Present System

64. The present system of high protection granted to import substitutes is in effect a device t get around the problem of the difference in efficiency, bv setting the price relations between the new domestically produced goods and the foreign-produced goods at a substantially different level than the one resulting from the efficiency of the basic primary export industry. It is also a device to divert capital from the import trade and real estate into new activities, by offering substantial profit margins.

65. If the analysis in the preceeding section is correct, however, it follows that the present system is only a partial answer to the problem; and being partial, it is a one-sided and therefore incorrect answer. If the key problem is to get around the basic price relations as determined by the most efficient export industry and thus to remove the straight-jacket they impose, this is needed throughout the economy and not only with respect to the import substituting activities catering to the domestic market; it equally applies to all potential new activities, including those that produce for the export markets; and it also applies as much to agriculture as it does to industry. In short, from a theoretical point of view, it would appear that incentives, in terms of favourable price-cost relations, should apply fairly equally to both the new import-substitution and the new export-oriented industries; and, more important, from the practical point of view, unless the incentives are applied fairly equally, the chances are that industrial growth will be arrested due to insufficient capacity to import caused by lagging exports (see part II, pp. 13-15).

66. If protection were only moderate, say 10-15 per cent, the dice would still be loaded against the export industries since their input costs would rise, but the effect would be at least kept within reasonable bounds. With protection rates of 30 per cent, 40 per cent, and 50 per cent, the dice are loaded too much.

67. This is not the only adverse feature of the present incentive systems. Import duties were originally introduced in developing countries as a revenue source: they were a near perfect substitute for sales taxes on manufactures, since virtually all manufactures consumed were imported. Now, sales taxes are generally imposed on goods for final consumption and not on raw materials; and among the consumer goods, they bear particularly heavily on those whose consumption is not very responsive to price (i.e. where the price elasticity of demand is low). These are mostly goods which are considered "luxury" goods - appliances, finer textiles, tobacco and alcohol, sugar. The rates of duty inevitably differ from product to product, depending on the price elasticity and on the political and fiscal considerations when they were introduced or subsequently changed. The revenue objectives of the tariffs are responsible for the extreme complexity of the tariff structures. On the other hand, in order to make the complex system administratively manageable, specific rates per unit of

weight are frequently in use instead of *ad valorem* duties.

68. As industrialisation begins and proceeds, it is the protective features of tariffs which have to be super-imposed on a most complex and special structure of revenue tariffs. The result is a mixture of the different elements, with different objectives and different techniques to achieve the various objectives.

69. The economic effects are far-reaching and frequently unknown until after the event. The greater incidence of duties on final goods than on semi-finished products and raw materials stimulates production of final goods on the basis of imported inputs and the manufacturers cash in on the difference. The greater incidence of duties on "luxury" goods stimulates their domestic production at the expense of the more needed products, until equivalent sales taxes on domestic production are introduced. The specific duties per kilogram on an industrial input which is produced and sold in several qualities, cheaper and more expensive, stimulates the consumption of the more expensive varieties, since the effective duty rate in this case works out lower.[8]

The Implications

70. Three conclusions follow from the analysis in paras.55-69.First, incentives are needed wherever the efficiency level in the traditional primary export industry differs substantially from the efficiency level in the rest of the economy; and these incentives may have to be quite high if the economy is to develop. Secondly, the system of industrial protection as an incentive device, which is a logical first step in industrialisation policy, has to be followed as soon as possible by incentives to resource-based activities, including export incentives,particularly in cases in which the rate of protection is high; otherwise, the economic system will become unbalanced, followed by external financial difficulties and then a check on growth. Thirdly, the present protective systems in

8. In Iran, for example, the duty on imported material for production of paints is charged per kilogram. Since there are many qualities of paints, the importer or user will minimise the duty incidence by importing the highest quality. The duty on sheet glass is also per kilogram. Since the value of glass varies depending on thickness in much greater proportion than in relation to weight, sheet glass bears widely different *ad valorem* duties.

the developing countries cannot perform the function expected of them:they have their origin in an underdeveloped non-industrial economy and their initial purpose has been exclusively fiscal. If protection is to serve developmental objectives, its present structure has to undergo a substantial modernisation and reliance for fiscal revenue has to be placed elsewhere.

71. These conclusions are applicable to Irān, in different degrees. The experience has shown that relatively high protection was needed to initiate industrial growth on a significant scale. Adverse effects of high protection on the rest of the economy have so far been kept within bounds, for several reasons. It is for the future that the above conclusions are particularly relevant. Unless sufficient incentives are given to the expansion of non-petroleum exports and unless the protection structure is modernised and rationalised, so that the resource-based activities can develop unhampered, it is likely that either external financial difficulties will ensue, or the rate of growth will slow down, or both.

Possible Evolution of the System

72. Views will differ on what should be the long-run objectives of the system of incentives. According to one view, the objectives should be a uniform rate of protection for all non-traditional activities, accompanied by an equivalent uniform rate of export subsidy for all exports except those whose production should not be expanded since foreign demand for the country's exports is inelastic. A possible variation of such a system would be a moderate extra protection, up to say, 10 per cent or so to be applied rigorously to products where a very convincing case of need and priority can be made. A contrary view would be that such a system would still leave too much leeway to forces currently operating in international trade with all its distortions, and that the ultimate outcome for growth would be uncertain; consequently, a varied pattern of protection and export subsidy would be necessary. How much a difference there would be in practical application of the two views in the case of a particular country is an issue which can be clarified only if an attempt at reform is carried out: it may turn out that the difference is not substantial, provided the fundamental points are agreed upon - the need for modernisation of the tariff structure and the need for reasonably equal

chances to the import substitution and to the resource-based activities.

73. Whatever the differences of view concerning long-run objectives, it is the immediate issues which have to be resolved first. With respect to protection: the present wide discrepancies in the tariff rates on different products, the accidental effects of the different rates, the unresolved issues of how much protection there should be on basic materials and on capital goods and what will be the effects on prices and on costs of final goods - are questions which have to be considered most seriously and then a rational protective system has to be developed with clear objectives and simplified techniques. Similarly, the issue of introducing export incentives in the form of export subsidies has to be equally seriously considered, in the light of the already acquired experience concerning the competitive position of the industry and of other activities and in view of the emerging problems in the balance of payments.

74. In the consideration of these two immediate objectives, the problems they are likely to give rise to must also be analyzed. The two major problems are the effects on domestic prices and the effects on government revenue. Higher protection for intermediate products and export subsidies will tend to raise domestic prices. Against this, there is the price- reducing effect of possible lowering of tariffs where they are excessive. Also, transitory measures to subsidise the domestic consumption of basic consumer goods whose prices would rise, are to be explored, as well as the effect on domestic prices of larger imports which would be possible due to improved export position. Introduction of export subsidies would have an immediate adverse effect on government budget: one would have to look at possible offsets, in the form of taxes or sales and elsewhere in the tax structure. A special point to be explored in the case of export subsidies is the magnitude of the risk of the importing countries introducing countervailing duties; this may call for consideration of the different techniques of export incentives.

Further Studies

75. The problem of prices, i.e. the possible reform of the system of incentives and the simplification of the tariff structure, commands priority among the subjects on which further work is needed. Other subjects, already discussed earlier in this report, include: location of

industrial and agricultural activities; the optimum size of individual projects that are undertaken; the problem of industrial finance; the export expansion to the Persian-Gulf; and the transport problem.

76. This does not exhaust the areas in which further analysis is necessary. One concern is the pricing of products for the home market, which Irān can produce in abundance at low cost, but cannot sell abroad beyond a certain quantity (e.g. petroleum). If such products were priced at a marginal cost for domestic uses, this would represent a powerful, and economically logical, stimulus for development of industries which use domestic materials on a substantial scale, i.e. industries in which Irān has comparative advantage. More generally, it is this principle of stimulating industries with high value added and low unit costs, now or potentially, which may serve as a guideline as to where resources should be concentrated to best advantage. It was mentioned before that the whole vegetable oilseeds - vegetable oils - meat production complex could be usefully re-examined to find out where the bottlenecks to rapid growth are and what measures are needed to remove them. The same applies to the cotton and wool economy, including forward linkages to ready-made clothing and the establishment of cashmere industries; the possibility of expanding on a large scale fresh and processed food industries, including freezing facilities and adequate transport network for the export markets; and the possible development of large-scale modern copper-using industries, in addition to petro-chemicals whose development is already in process. Another problem area which should be examined is the possibility of expanding the export market for Persian rugs on a large scale, by developing a medium-priced variety for the middle-income groups in Europe and America, while still retaining the monopoly in the luxury-priced product for the high-income market. In the absence of such development it is other countries which may take over the medium-priced market. In short, the whole complex of commodity output, industrial output as well as agricultural output would have to be looked into parallel with any re-examination of incentive policies.

77. In order to explore the urgent issues listed in paras. 75-76, it would be necessary to establish a special working group consisting of experts of the Plan Organisation, Ministry of Economy, Ministry of Agriculture, Ministry of Finance, the Industrial and Mining Development Bank and

where relevant the Central Bank. Such a working group may be asked to submit its preliminary report on the most urgent issues by the end of the year.

APPENDIX I

SELECTED MANUFACTURED GOODS: PRICE CHANGES BETWEEN 1959 and 1968

Product	Price in 1968 as per cent of price in 1959	Product	Price in 1968 as per cent of price in 1959
Veil Cloth	174.2	Sewing Machines	98.9
Carpets	145.1	Brick	98.1
Tea Glass	135.3	Metallic Chairs	96.8
Bicycles	131.7	Light Bulbs	96.6
Enamelled Plate	124.1	Bath Soap	96.5
Rubber Shoes	120.2	Radios	95.9
Towels	117.3	Vitamin "C" Tablets	91.7
Sheet Glass	116.5	Slippers	91.5
Sugar and Sugar Cubes	116.2	Penicillin Ampules	88.8
Non-alcoholic Beverages	115.6	Plastic Sacks	88.6
Matches	112.8	Sulphatiazol Tablets	87.0
Woollen Suits	108.3	Woollen Blankets	82.1
Thread	109.3	Cement	80.2
Bicycle Tires	108.4	Soap	80.2
Chintz	107.5	Aluminum Ware	80.1
Undershirts	106.3	Vegetable Oil	72.4
Space Heaters (port)	105.3	Plastic Shoes	69.5
Cooking Stoves	104.5	Detergents	57.8
Ichtiol Ointment	104.3		
Samovars	104.2		
Aspirin	103.0		

Source: Central Bank of Iran.

that export growth is a priority for developing countries, both to enable them to transfer smoothly debt service on their external liabilities and to help assure a steady flow of their imported inputs. In addition, The World Bank, in its "structural adjustment loans" (SALs) provides financing for export expansion on sectorial and institutional bases. Between 1980 and early 1984, in 14 out of 16 countries which had received SALs, one of the lending objectives was "export incentives and improved institutional support."[10] It is not clear from the available data how much of this lending (and other export lending) was for expansion of traditional export commodities rather than manufactures. Such primary product expansion, while it will normally assist the individual borrower over the long run, raises serious issues in periods of depressed markets, as by adding to supplies it depresses the market further, thus affecting adversely producers as a group. "The contradiction in the situation is that while it would be in the interest of commodity exporting countries as a whole to limit or reduce their productive capacity in a period of persistent oversupply, it appears to be in the interest of each country individually to increase its share of the global market. However, this latter route is inevitably costly and ultimately self-defeating since it further adds to downward pressure on prices."[11] The issue of lending for commodities in surplus has been extensively discussed within the Bank, but it is not known that it has been satisfactorily resolved: it is a difficult issue as it sometimes affects the least advanced developing countries with few obvious noncommodity alternatives. Devaluations in commodity-producing countries, frequently a key element of IMF conditionality, also have the price-depressing effect on the world market as they stimulate additional export sales despite the surplus.[12] What is missing is an international commodity production plan.

III 3 Management of Public Enterprises

Public enterprises in infrastructure, goods and services production, and trade represent a large proportion of the total in

10 Progress Report on Structural Adjustment Lending, *The World Bank, R84-150*, 6 June 1986, p. 7.
11 Alfred Maizels, *The Terms of Trade and the External Financing Problems of Commodity-Exporting Developing Countries*, Helsinki, 1986, p. 34 (mimeo.).
12 An IMF staff study recognizes this, but argues that the effect will normally be small, compared with other forces operating in commodity markets. (Morris Goldstein, *The Global Effects of Fund-Supported Adjustment Programs*, March 1986.) The adverse effect remains, however, and its size can be determined only by special product-by-product investigation.

many developing countries, and their management and finances have a major effect on public finance and credit in general. Management weaknesses have been frequent, mostly because of political patronage or insufficient operational autonomy; and finances have frequently been weak because the enterprises have been used as a vehicle for subsidization of consumption, as a source of employment, or as a conduit for irregular transactions. At the same time, first-rate publicly-owned enterprises exist in a number of developing countries, in some cases at the outer edge of technological advance in key priority areas (*e.g.*, energy).

The World Bank, as an investment project lender, had concentrated on "institution building" at the enterprise and sector levels, *i.e.*, the establishment or reconstruction of publicly-owned enterprises, mostly in infrastructure, insisting on autonomous sources of finance and independent management.[13] Its project loans have been conditioned by the borrowing country accepting these two principles. This has frequently given rise to disputes, particularly concerning prices which the enterprise will charge for its services (*e.g.*, electricity rates, water rates, transport tariffs, port charges, etc.), with the borrowing country normally insisting on lower prices, and the Bank asking for more; but none of these disputes seem to have developed into a major country-Bank confrontation, although they have taken time to resolve and have therefore slowed down investment. Dr. Richard Goode, a former high official of the IMF staff, after noting that the Bank "seems to enjoy more harmonious relations than the Fund does with the governments of developing countreis", suggests that "the ability of the Bank to avoid confrontation with member governments in the past may have been due largely to the multiplicity and relatively small size of its individual loans. Applications for project and sector loans can be delayed or refused without seeming to render an unfavourable judgment on the member country's broad policies and creditworthiness, but it may be harder to avoid such an implication if a structural adjustment loan is refused."[14]

The developing countries have become increasingly aware of the need to improve and upgrade the operations and management of their public enterprises. An important step in this direction has been the establishment of the the International

13 An extensive treatment of the Bank's practices is given in: Warren C. Baum and Stokes M. Tolbert, *Lessons of World Bank Experience*, Washington, D.C., 1985.

14 Richard Goode, *Economic Assistance to Developing Countries through the IMF*, The Brookings Institution, 1985, pp. 59-60.

Centre for Public Enterprises in Ljubljana, Yugoslavia, aimed at mutual exchange of experience and mutual assistance.

III 4 Agricultural Prices

Concerned with the agricultural lag a number of developing countries and their rising food imports, both the World Bank and the IMF have insisted on improvement of agricultural prices in these countries' internal markets. A World Bank staff study of "price distortions" during the 1970s in 31 developing countries from all continents found that in seven (22%) agriculture was effectively highly taxed.[15] Another Bank staff study, focussed on agriculture in 31 African countries also during the 1970s, found that ten (33%) showed a "high farm price discrimination", defined to exist where farmgate prices are more than 40% below import or export parity prices on the average.[16]

The Bank has normally made its agricultural lending conditional on price improvement where warranted. It is not clear in how many Fund programmes has this been singled out as a specific objective, although the Fund's general position on this issue is clear.

The need to provide adequate price incentives in agriculture is now recognized in a very large number, perhaps most, developing countries. In Asia, this happened already in the 1960s.[17] In Africa, it is happening now; there is also evidence that producer prices for food commodities in some African countries already were increasing significantly faster than world prices in the 1970s.[18] In five significant agricultural producing countries in Latin America and the Far East for which comparable time series are available, the "relative protection ratio" of agriculture compared to industry moved up from an average of 0.70 in the 1960s to an average of 0.82 in the late 1970s or early 1980s.[19] As is to be expected, industry continues to

15 Ramgopal Agarwala, *Price Distortions and Growth in Developing Countries*, World Bank Staff Working Papers No. 575, July 1983, p. 16.

16 Kevin M. Cleaver, *The Impact of Price and Exchange Rate Policies on Agriculture in Sub-Saharan Africa*, World Bank Staff Working Papers No. 738, April 1985, pp. 8-9.

17 See, Raj Krishna, Agricultural Price Policy and Economic Development, in: *Agricultural Development and Economic Growth*, edited by H. M. Southwart and B. F. Johnson, Ithaca, New York, 1967.

18 Dharam Gai and Lawrence Smith, *Food Policy and Equity in Sub-Saharan Africa*, World Employment Research Programme, ILO, Geneva, August 1983.

19 The World Bank, *World Development Report 1986*, p. 62. A ratio of 1.00 would indicate that effective protection is equal in both sectors: a ratio smaller than 1.00 means that protection is in favour of industry. The five countries covered are Brazil, Colombia, Mexico, Philippines and South Korea.

be protected relative to agriculture; but the degree has been reduced.

In contrast to their activities to improve the terms of trade of agriculture within developing countries, the Bretton Woods institutions have not given comparable attention to improving the terms of trade of developing countries-commodity producers in the world economy. The Fund has a Buffer Stock Facility to assist producer-consumer commodity arrangements, but its operations have been limited, partly because there have been too few of these arrangements. The Bank has refrained from entering the field of international commodity stabilization, and so have the regional development banks. The issue of international commodity stabilization remains open on the international agenda.

IV WEAKNESSES OF THEORY AND POLICY

Conditionality as now practiced rests on three elements of economic policy: first, monetary programming which is a particular form of credit policy, based on fixed money supply targets or predetermined money supply growth rates, used as a device to reduce inflation and, accompanied by devaluation in most cases, to turn around quickly the balance of payments; second, financial liberalization, expected to result in a positive real rate of interest, which would lead to increased savings and better use of capital; and, third, import liberalization, expected to improve domestic efficiency through foreign competition and availiability of imported inputs, and to lead to optimum resource allocation. Cutting across these elements and in a sense going beyond them is, fourthly, a specific philosophy of economic policy and development strategy towards which the leading financial institutions lean. They have a preference for market solutions both in normal times and in periods of crisis as opposed to government intervention; and they press the case of free trade as opposed to specific country development strategies. These four propositions are discussed below.

IV I Monetary Programming

Monetary programming and the associated stringent credit ceilings have not proven a successful experience either in developed or developing countries. In developed countries, its

fundamental weakness has been the inability to foresee the velocity of money (*i.e.*, money/GDP ratio), a variable showing major and sudden shifts in response to changing expectations and lately to deregulation of financial markets and introduction of new credit instruments which have blurred the distinction between money and securities and made the operating target – money supply – virtually impossible to define. An unforeseen and sudden increased or decreased readiness of the public – population and business – to hold cash balances has frequently made the *ex-ante* monetary programmes either insufficient or excessive, with highly destabilizing effects on interest rates and the economy in general. Some important countries have been compelled to change monetary targets mid-stream or drop them altogether, in order to avoid shortages of credit, sky-rocketing interest rates, and the associated declines in output and sales of assets at distress prices.

Developing countries moving from high inflation to stabilization through an *ex-ante* targeted reduction in money supply have experienced massive shortages of domestic liquidity when due to still existing inflationary expectations the prices did not fall as targeted, with the result that output, employment and real wages fell, while real interest rates soared.[20] Furthermore, stringent credit controls will have the effect of reducing output to levels below those consistent with either balance-of-payments improvement or a reduction in inflation itself whenever the country experiences "cost-push" inflation, frequently resulting from decontrol of prices and elimination of subsidies under a stabilization programme.[21] "The basic point is that supply and demand both determine price. A policy which tries to restrain demand, and ends up by reducing supply by even more than it reduces demand, will be inflationary. And in the short run, supply may depend rather critically on the volume of credit, more so in developing countries than in advanced industrialized economies."[22] Requests for short-term credit to finance production for exports have been turned down merely in order

20 Joseph Ramos, *Stabilization and Adjustment in the Southern Cone of Latin America*, in SID/North-South Roundtable, *Adjustment with Growth*, Islamabad, 1985, p. 96.
21 S. K. Rao, *On Negotiating with the IMF: A Note*, Seminar on Adjustment Programmes, Commonwealth Secretariat, London, June 1985, p. 3 (mimeo.)
22 Kemal Dervis, 'Comment' in *Economic Stabilization in Developing Countries*, edited by W. R. Cline and S. Weintraub. The Brookings Institution, Washington, D.C., 1981, p. 503. In the same vein see Peter M. Keller, 'Implications of Credit Policies for Output and the Balance of Payments' in IMF, *Staff Papers*, Vol. 27, No. 3, 1980, pp. 455-6.

to stay within overall credit ceilings.[23] It follows that broad guidelines rather than specific numbers should govern monetary policy.[24]

Devaluation has been a part of adjustment in the majority of IMF-supported stabilization programmes: 55% of these during 1980-84 required "liberalization and reform of exchange rate arrangements."[25] There have been bitter disputes about the need, the extent and the effects of devaluation. Professors Krugman and Taylor have argued that instead of an expected economic expansion, devaluation may lead to a contraction due to a transfer of real purchasing power toward economic sectors with high marginal propensity to save, which may then create an excess of savings over planned investment and lead to a reduction in real output and imports.[26] A recent IMF staff study indicated that in a developing country experiencing a fall in export receipts due to an external price fall, devaluation may fail to have the expected favourable effect on the balance of payments as domestic spending it generates could lead to a further trade deterioration.[27] Dr. Buira, a distinguished Mexican economic official and a former Executive Director and member of the IMF staff, has drawn attention to low supply elasticities in developing countries which may frustrate the expected effects of devaluation:

The usual Fund analysis of the impact of devaluation on aggregate supply often neglects the consideration of elesticities. What happens, for example, if the increase in the price level of traded goods in terms of domestic currency, caused by devaluation, does not lead to an increase in the output of traded goods? In other words, what happens when, as is frequent, the price elasticities of the supply of exportable and import-competing goods is very low in the short run? The results would be that imports would not decline much in the short run in response to a devaluation, given the absence of adequate home-produced substitutes. In fact, imports will decline largely due to declines in income rather than as a result of relative price changes induced by the devaluation. Taking into account that exports of LDCs are often

23 In Jamaica, in the latter half of 1985, the monetary constraints became so severe that a commercial bank cut off credit to 807 garment manufacturers who needed it because of inevitable lag in the receipt of export proceeds from the overseas contractors, resulting in work force reductions and plant closures. (Paul Chen-Young & Associates, *Critical Poverty Study-Jamaica*, Kingston, 26 September 1986, p. 40 (mimeo.)).

24 This is the view of a number of analysts, see Dragoslav Avramovic, *The Role of the International Monetary Fund: The Disputes, Qualifications, and Future*, in John Williamson ed., *IMF Conditionality*, Washington, D.C., 1983, p. 600.

25 IMF, *Fund-Supported Programs, Fiscal Policy and Income Distribution, op. cit.*, p. 12.

26 Paul Krugman and Lance Taylor, *Contractionary Effects of Devaluation*, Journal of International Economics, Amsterdam, Vol. 8, August 1978.

27 Iqbal M. Zaidi, *Currency Depreciation and Nonclearing Markets in Developing Countries*, IMF Staff Papers, Vol. 33, No. 2, 1986.

inelastic in the short run, the final impact of devaluation on the balance of trade is uncertain, while it is clear that it can induce contractionary effects on output and employment.[28]

Similarly, Dr. Please, a former high official of The World Bank, stresses the limitation of devaluations in Africa in view of other supply constraints: "Exchange rate changes and their impact on agricultural incentives in African countries must, therefore, be conceived and implemented in the context of a package of measures. Moreover, the degree of distortion in the incentive system is so large and politically difficult to handle, and the institutional, agronomic and other barriers to a rapid supply response from farms are going to take so long to deal with, that the package of measures can only be conceived and implemented over many years."[29] And Professor Mellor adds that "where, as is frequently the case, total agricultural supply response is small, the main impact of agricultural (food) price increases may simply be to increase poverty."[30] Finally, Dr. Blackamn, Governor of the Central Bank of Barbados, summarizes the skepticism, presumably reflecting the Caribbean experience:

In LDCs the elasticities of foreign demand for exports, and especially of the domestic supply of goods for export, are likely to be negligible. Lower export prices merely result in reduced foreign exchange earnings; increased import prices lead only to increased domestic and export prices, since a large proportion of inputs into domestic production must be imported... Devaluation as a tool of short-term balance of payments adjustment is contra-indicated, successive mini-devaluations make even less sense. To be effective such devaluations must be sharp enough to preclude the possibility of wage catch-up by trade unions."[31]

None of the above proves that devaluation can or should be avoided when domestic costs and prices are out of line with international levels across the board. In fact, the experience generally suggests that a slight sustained undervalued rate is likely to lead to a sustained rapid and diversified export growth. (I am assuming that traditional primary product exports are

28 Alfred Buira Seira, *Recession, Inflation and the International Monetary System*, World Development, Volume 9, No. 11-12, Novembar-December 1981, p. 1124. Dr. Buira is now Deputy Governor of the Bank of Mexico.

29 Stanley Please, *The Hobbled Giant, Essays on The World Bank*, Boulder and London, 1984, p. 67. See also, Tony Killick 'Balance of Payments Adjustment and Developing Countries' in *Problems of International Money, 1972-85*, edited by Michael Posner, IMF-ODI, 1986, p. 86.

30 John W. Mellor, *Agricultural Change and Rural Poverty*, International Food Policy Research Institute, Food Policy Statement No. 3, October 1985, p. 3, quoted in G. K. Helleiner, *Policy-Based Lending and The Work Bank: Prospects and Possibilities*, March 1986, p. 16 (draft, mimeo.).

31 Courtney N. Blackamn, *Adlith Brown Memorial Lecture*, Central Bank of Barbados, January 1986, p. 10.

controlled to avoid world price falls.) But the above arguments strongly suggest that a devaluation should not be undertaken lightly, but in the context of other measures to augment export supplies in a lasting way. Otherwise devaluation will only keep re-igniting domestic inflation and the other way around, depriving the economy, in the process, of a stable framework for making sensible investment decisions – the value of money.

IV 2 Financial Liberalization

It is now generally agreed that increase in interest rates – a major argument for financial liberalization – cannot be confidently expected to lead to an increase in savings. According to the studies of the IMF staff:

The evidence from developed and developing countries alike is not quite conclusive in regard to the interest elasticity of savings. For the United States, income and wealth are found to have a more predominant influence on personal savings than interest rates. For less developed countries, even allowing for the dubious nature of statistics, the evidence points toward the same kinds of doubt about the interest elasticity of savings.[32]

Despite the amount of research expended on the responsiveness of savings in general, and in developing countries in particular, it is still uncertain whether an increase in interest rates will, on balance, raise the savings rate.[33]

This latter IMF study states that some recent findings indicate a positive response of savings to increases in *real* rather than nominal interest rates; but another author finds little evidence on this question, and the IMF study concludes that "it is evident from the empirical studies reviewed that the direct response of domestic private savings to variations in real interest rates is weak."[34] This leaves allocative efficiency and the attraction of foreign capital (deposits) as the main reasons for raising the rates of interest. Negative rates would lead not only to excessive monetary expansion, but also to under-taking poor investments alongside good ones. However, subsidized rates to

32 Deena Khatkate, *Analytic Basis of the Working of Montery Policy in Less Developed Countries*, in: Money and Monetary Policy in Less Developed Countries, W. J. Coats and D. R. Khatkate (ed.), Oxford, 1980, p. 134.

33 Mohsin S. Khan and Malcolm D. Knight, *Fund-Supported Adjustment Programs and Economic Growth*, IMF, Washington, D.C., 1985, p. 14

34 *Ibid.*, p. 13. The studies reviewed are: Maxwell J. Fry, *Savings, Investment, Growth and the Cost of Financial Repression*, World Development, Vol. 8 (April 1980); Maxwell J. Fry, *Savings, Investment, Growth and the Terms of Trade in Asia*, February 1984, unpublished, Irvine, California; Alberto Giovannini, *The Interest Elasticity of Savings in Developed Countries: The Existing Evidence*, World Development, Vol. 11, July 1983; and Donald McDonogh, *The Determinants of Saving Behaviour in Latin America*, unpublished, IMF, April 1983.

underprivileged sectors are justified when they serve to correct existing disequilibria (*e.g.*, underpricing in agriculture): elimination of a subsidy in this case – a partial equilibrium – would make the overall situation worse. This situation is encountered frequently in conditionality applied to rural lending; and lender insistence on subsidy elimination is wrong in these cases.

A major point in dispute concerns interest rate policy during adjustment still marked by inflation. Pushing interest rates to positive real levels at all cost under these circumstances exacerbates inflation and, as has frequently happened, ends up with extremely high real rates which are then very difficult to bring down and are destructive of investment and growth for years. An internal agency study (1983) found that "rising real credit was basically the debt of the corporate sector, and so corporate debt-to-equity ratios increased. High real rates transferred producers' income from firms (equity holders) to rentiers (depositors, bondholders, foreign creditors and the like), allowing for less accumulation of retained earnings and creating a need for more borrowings to finance asset positions. And, of course, these borrowings were forthcoming because real balances of domestic credit instruments were rising in response to high real rates. Overall, we might say that sustained high real rates of interest have had a corrosive effect on the structure of enterprise finance."

Professor Taylor, looking at the same phenomena in a macro perspective, on the basic of WIDER country studies of stabilization and adjustment, 1986, observed:

It is often estimated that interest rate increases will stimulate savings, for example in Egypt, Turkey and elsewhere. Two questions arise: is the effect present and large enough in quantitative terms to matter? If so, what are the implications of a higher national savings rate? The evidence on the first query is far from clear. Raising a rate of return to a particular asset (say, bank deposits) is likely to induce a portfolio shift in its direction, but econometrics and country experience suggest that overall savings do not rise.[35] Even if they did, the outcome would be output contraction unless steps were taken to stimulate investment to absorb the extra saving supply. The market probably would not do the trick, especially if the whole interest rate structure was jacked up to try to draw forth more saving in the first place. Second, there is the possibility that higher interest rates will not only cause contraction, but

35 Professor Gouda Abdel-Khalek, in the WIDER study on Egypt, notes that raising interest rates on bank deposits reduces the maret value of bonds, so that the observed increase in bank deposits in Egypt may have been at the expense of other types of financial assets, *i.e.*, government securities. *(Recent and Future Stabilization Experience in Egypt*, Helsinki, July 1986, pp. 17-18 (mimeo.)).

also inflation via working capital cost push...[36]

From the viewpoint of economic growth, the desirable long-run policy is that of low positive real rate of interest: it will maximize investment without discouraging savings. This seems to have been the Japanese experience. If a country can attract foreign deposits – perhaps from its nationals living abroad – it should offer an extra interest margin. Countries which are not able to control capital outflow must offer a minimum critical level in competition with international interest rates in order to avoid a "liquidity trap" due to demand for foreign financial assets.[37] According to a recent Caribbean study, "The scope for independent interest rate setting is limited to a corridor around the ruling rate on the international financial market where the costs of transferring funds outweigh the potential interest gain, a margin we estimate at one or two points."[38] The margin should be larger in more closed economies.

IV 3 Import Liberalization

The dominant view held in major lending agencies is that import liberalization is needed to improve the competitiveness of the entire economy, through associated pressure on costs, taking in stride, as an inevitable price of progress, closure of firms unable to stand the competition of additional imports. The improvement in allocative efficiency, it is expected, will lead to rapid export growth, and this will recoup any losses which may have occurred in the meantime.

The country studies in the WIDER project have difficulty in accepting this import liberalization thesis. The study on Peru argues that the pressure for import liberalization in the midst of a severe balance-of-payments shock – and the rejection of price controls as a supporting instrument in an anti-inflation programme – has complicated and impeded the design of a programme better suited to the situation.[39] The study on Mexico states that import liberalization deteriorates "the tradeables-non-tradeables price ratio... this reduction will shift

36 Lance Taylor, *Economic Stabilization – Recent Experience in the Third World*, WIDER, Helsinki, August 1986, pp. 30-31 (mimeo.).
37 Nora Lustig and Jaime Ross, *Mexico's Adjustment Program: The Unending Search for Stability Through Cuts in Public Spending 1982-86*, WIDER, Helsinki, August 1986, p. 14.
38 DeLisle Worrell, *Adjustment Policies in Small Open Economies: Lessons from the Caribbean Experience*, Central Bank of Barbados, January 1986, pp. 37-38 (mimeo.).
39 Dr. Richard Webb, *Domestic Crisis and Foreign Debt in Peru*, WIDER, Helsinki, August 1986, p. 25.

Few would quarrel with the aspiration to remove or reduce import controls wherever possible. They tend to introduce inefficiency and corrupt practices when they are long maintained. But the timing of their removal and/or rationalization must be determined in the overall context of the economy's circumstances. Some would also say that liberalization is best undertaken in the context of GATT bargaining. To advocate liberalization during periods of foreign exchange crisis is to risk the imposition of even greater economic costs upon an economy already operating under stress and below capacity. Premature and ill-timed liberalization episodes will set back the prospect for greater efficiency and improved overall economic performance in the longer run.[46]

Implicit assumptions of the trade liberalization model are: first, that there is full employment in the country undertaking import liberalization, so that the labour losing jobs in industries which cannot survive, will quickly find jobs elsewhere, probably at better wages; and secondly, that the country can afford additional imports due to liberalization, and if it cannot, it should devalue somewhat more than it would otherwise do, so that it can pay for additional imports through additional exports. Neither of these two assumptions is valid in most developing countries. The labour made redundant is added to the army of the unemployed, at least until new export opportunities arise which will take time; and additional devaluation will contribute to a reduction of real wages through its effects on domestic prices, and if the country is a primary exporter (which in most cases it will be), devaluation may contribute to a deterioration in its terms of trade.

The above is not to say that cutting overly protective tariffs and monopolistic profits generated thereby and through rigid import quotas is a bad policy. Rather the emphasis here is that reform of the protective system should be pursued at a deliberate speed, with due care for employment, and, to the maximum extent possible, in exchange for trade concessions granted by other countries to our country's exports. Only as export industries expand and full employment is approached, one can embark on reducing import protection more generally, starting with the highest rates and moving down, making always certain that full employment is sustained.

Deep involvement of financial agencies in import policy matters of their debtors is a relatively recent phenomenon. In the inter-war period, financial missions headed by Dr. Kemmerer to

46 G. K. Helleiner, *Policy-Based Lending and The World Bank: Prospects and Possibilities*, March 1986, p. 17 (draft, mimeo.).

a number of developing countries, which have some resemblance to the missions of present international financial agencies, handled currency stabilization, central bank and general banking reform, and fiscal system reforms, but Dr. Kemmerer refrained from trade matters.[47]

IV 4 Differences in Economic Policy and Development Strategy

Differences between the key lending agencies and a varying number, usually large, of developing countreis can be summarized under two headings:

(a) Selective or generalized policies of adjustment to shocks;
(b) Is there room for government intervention in the pursuit of a specific long-run development strategy?

Adjustment to shocks. The IMF staff has provided a lucid description of its policy and guiding principles:

Aside from monetary [credit restraint] and exchange rate policies [frequently devaluation], a typical Fund programme calls for fiscal measures, such as reductions in government expenditures and increases in taxation, increases in domestic interest rates and producer prices to realistic levels,... trade liberalization, and wage restraint... Although a theoretical case can be made for controls and restrictions in the short run, in practice it has proved difficult to manage such systems efficiently and effectively over time. Furthermore, such policies, by introducing rigidities in the economy and creating incentives for the inefficient use of resources and forms of production, can turn out in the long run to be counter-productive and damaging to the growth potential of the economy... The Fund has consistently opposed the introduction of new restrictions, as well as the intensification on a permanent basis of existing restrictions and other distortions in the trade and payments system.[48] Hence a deflationary decline in output for a period is inevitable and is "a necessary part of the adjustment to eliminate underlying imbalances in the economy."[49]

WIDER country studies have confirmed the expectation that output would fall in a generalized adjustment. They have argued that a selective adjustment, relying in part on controls, would have caused less damage to output, investment and the position of poor people. The studies could not confirm or deny the thesis of damage to long-run growth arising from controls and selective adjustment: such a thesis is beyond scientific proof, except some time after the event in a particular country, and even then it will

47 Barry Eichengreen, *House Calls of the Money Doctor: The Kemmerer Missions to Latin America*, Harvard University-WIDER, June 1986.

48 Kahn and Knight, *op. cit.*, pp. 2-3.

49 *Ibid.*, p. 5

be a subject of controversy in many cases.

Differences of views on the appropriate response to shocks are difficult to reconcile. According to Governor Blackman, speaking from a position of strength in a country which has managed the crises remarkably well:

...the perspective of my lecture reflects my experience as a contributor to economic policy-making in Barbados over the past thirteen years. Although there have been broad areas of agreement between the IMF and the Barbadian authorities, our policies throughout the last fifteen years have been based on economic principles which, from the conventional IMF-World Bank perspective, must be viewed as distinctly heterodox. The major source of departure from the IMF-World Bank economic doctrine over the years has been over the concept of stable equilibrium and the efficacy of the free market both in the adjustment process and in the promotion of economic development.

For example, upon realigning our currency from the pound sterling to the U.S. dollar in July 1975, the Barbadian authorities revalued upwards by 10%. We went on to enjoy five of the most prosperous years in our economic history and have maintained that parity ever since. In the high inflation years of 1973 and 1974, we rejected the prescription of positive interest rates; by 1976 inflation had fallen to 6%. Since 1977 we have rejected the approved global credit controls which discriminate in favour of the productive sectors. I think we have done much better than many who did otherwise.[50]

The dilemma facing policy formation in a developing country, the uncertainties about the outcome of government intervention, and the political inevitability of intervention in the presence of major economic shocks are set out by Dr. Richard Webb, a distinguished economic scholar, formerly on The World Bank staff, then Governor of the Central Bank of Peru in both the previous and the present administration, and now Economic Advisor to the Prime Minister, in a 1986 study:

The causes of collapse, and of the failure to recover in the last two years, are not easy to unravel... Idle capacity and unemployment grew rapidly during 1983 as overall demand was reduced by public expenditure cuts and by capital flight created by rising inflation and generalized uncertainty. Efforts to increase the fiscal take by raising gasoline and other controlled prices along with a faster daily devaluation rate, pushed inflation into three digit levels for the first time. The economy seemed to be caught in a series of vicious circles in which further adjustment efforts had both positive and negative effects, exacting a high price in both inflation and recession, and in political erosion, for marginal fiscal and balance-of-payments improvements. Certainly, by late 1984, the severity of adjustment efforts could not prevent the eventual breakdown of debt service.[51] The [generalized] approach to adjustment proved to be highly inefficient in cost-benefit terms.

50 Blackman, *op. cit.*, pp. 4-5.

51 Compared to 1982, GDP per capita in 1985 had fallen 13%, wages in the modern sector 35%, imports 58%, investment 39% and food subsidies 93%. (Webb, *op. cit.*, p. 20).

A more selective approach to adjustment would probably have been more effective. In particular, a more direct attack on the balance-of-payments deficit, combining greater devaluation with import and capital controls, would have reduced the burden on recessive income-adjustment mechanisms, including the sharp reduction of government expenditures. Industrial policy could have been even more selective, supporting activities that could generate exports or save on imports using idle capacity, and also providing quicker and more supervised financial support where the threat of bankruptcy was causing output reduction.

These suggestions add up to a heroic agenda for a country with a particularly weak administrative base and little experience in such efforts. Also, direct interventions invariably give rise to distortion, corruption and inefficiency. Nevertheless, it is hard to accept that those costs could have been larger than the massive output reduction, unemployment, and impoverishment that actually occurred.[52]

Development strategy. The two schools in development theory – "structuralists" and "neoclassicists" – have been struggling for influence in the development finance institutions, and particularly The World Bank, since the beginning of its operations. The neoclassicists have been in ascendance during the last ten years. The conflict concerns the role of government in development strategy and policy. Neoclassicists argue that this role is simply to establish an economic environment in which free market prices will realize the efficient allocation of resources. The neoclassicists advocate "a neutral" policy regime, meaning that policies should not selectively favour priorities of sectors and industries. They allege that there are few inherent market failures and that existing market imperfections are by and large due to policy failures. The core of neoclassical prescription for a neutral policy regime is free trade. Pushed to its logical conclusion, the neoclassical view denies the need for any industrialization strategy and corresponding protection. If, as a practical matter, protection must be given, tariffs should be low and equal, in effective terms, across industries.[53]

The success of the newly industrializing countries in East Asia, and particularly South Korea, in penetrating export markets and absorbing modern technology, was initially taken as a proof of the validity of the neoclassical view. Detailed research has shown that the proof is not there. "A case for liberalization cannot be based on an impartial reading of Korean economic history. The evidence supports the view that both in the 1960s and 1970s,

52 *Ibid.*, pp. 21, 22-23.
53 Howard Pack and Larry E. Westphal, *Industrial Strategy and Technological Change*, Journal of Development Economics, 22 (1986), pp. 88-89.

government intervention underscored the emergence of a solid industrial structure."[54] "Selective intervention has contributed to the success, and it has done so by accelerating the rate of industrial growth with little if any compensating loss in efficiency terms."[55] Korea has moved from protected import substitution to export expansion supported and guided by the government. Like in the case of Japan, it is not the absence of government support and the free trade, but intelligent use of incentives, protection and other industrial policy which have contributed to the establishment of a powerful and most modern industry.

Excessive preoccupation with getting protection down has pushed into the background the fundamental issues of transfer and absorption of technology and its organizational arrangements. It has been forgotten that "tariffs or quantitative controls are superior to free trade if the resulting immediate loss in users' surpluses is more than offset by restriction-induced future gains in users' surpluses. Thus, in the absence of perfect tradability, restrictions to promote the acquisition of technological capability can be superior to free trade, since the acquisition of technological capability can lead to lower prices and to differentiated products that would not otherwise exist."[56] There are also new findings concerning infant industry protection. "The traditional version of the argument relied either on imperfect capital markets or external economies to explain why temporary protection was needed to establish an industry. In the new version, the emphasis is instead on increasing returns internal to a firm. A protected home market allows firms to move down their marginal cost curves (or down their learning curves in a dynamic model), lowering costs and raising market shares in all markets. A striking conclusion is that a protected market may actually serve as a springboard for increased exports. Recent simulation analyses... seem to confirm the importance of this effect for several actual industries. The problem with applying the new infant industry argument – better described as the argument for "import protection as export promotion" – to LDCs is that it depends on the domestic market being fairly

54 Amsden, *op. cit.* Colin I. Bradford, Jr., 'East Asian Models: Myths and Lessons' in *Development Strategies Reconsidered*, edited by John P. Lewis and Valeriana Kallab, Overseas Development Council, Washington, D.C., 1986, discusses the extensive role of governments in South Korea and other East Asian Countries.
55 Pack and Westphal, *op. cit.*, p. 97.
56 *Ibid.*, p. 117.

large."[57] Hence the need for economic cooperation of developing countries in suitable cases, to build an internationally competitive industry.

Most developing countries have learned from their excesses in pushing extensively with industries which they were unable to use effectively either because specific projects failed or because foreign exchange shortages blocked the supply of imported inputs and spares; many, perhaps most, are now giving priority to export development; and most are aware of the need to promote agricultural growth. Neoclassicists, through their writings and advice have contributed to this new awareness. But virtually all developing countries remain committed to industrialization, which calls for incentives and other government support. The ongoing depression of their export commodity prices serves to strenghten this commitment. There is the danger of a serious strain in the relations between developing countries and development finance agencies unless the latter relax their pressures on free trade.

V SUGGESTIONS FOR A NEW APPROACH

Three suggestions are made below. First, the financing agencies should encourage member country governments requesting adjustment assistance to submit their own programmes of adjustment; the present practice of the agencies preparing these country programmes should be discontinued. Secondly, the agencies should decide on their loans on the basis of their assessment of the debt servicing capacity and financial management of the borrowers, with loan conditions being normally confined to factors bearing on these two areas; this would modify the present primary emphasis of conditionality on influencing national economic policies in a specific direction. Thirdly, a system of regular exchanges of information and economic policy views between the borrowers and the agencies should be instituted; this would enable the policy dialogue to be continued, but in a consultative manner.

V 1 Country Programme Initiatives

The World Bank is on record as recommending that member countries have the initiative for the preparation of adjustment

57 Paul Krugman, *New Trade Theory and the Less Developed Countries*, WIDER, Helsinki, August 1986, pp. 25-26 (mimeo.).

programmes. The Bank's 1986 report on Africa lists several areas in which further steps should be taken to strengthen the system of developed-developing country cooperation. The proposed reforms start with:

First, governments in Africa must be seen to have the prime responsibility for designing their adjustment and investment programes and for coordinating aid and other financial flows. Donors can assist in the task – but they should not undermine this responsibility by trying to negotiate their own favorite package of policy reforms or by promoting their own pet projects. To this end, the African countries must strengthen their core ministries of finance and planning, and the units that coordinate their foreign assistance.[58]

Mr. Conable, the Bank's recently appointed new President, "hoping to avoid frictions over lending conditions, says he wants the developing countries themselves to come up with the policy changes that they think will spur faster growth – rather than have conditions imposed by the institution."[59] A World Bank staff study suggests that "the creation of an institutionalized process under which reform is analyzed and pursued may be more important than achieving policy reform targets involving specific price and exchange rate levels. Prices and exchange rates can always be changed again, in the wrong direction. However, solidly established processes for analyzing and implementing policy reform may have a more durable impact in the long term. In addition, the process of analyzing may uncover some of the unknowns regarding agricultural growth. Thus the reforms pursued should be regarded as a process, rather than a condition to be achieved."[60]

I have not come across similar statements of the Fund, but they may exist. A recent Fund staff study, talking about the present practice, says that the Fund designs country stabilization programmes; but another study stresses that they are "Fund-supported" rather than "Fund" programmes, adding that "the country plays an active role in its formulation."[61] The issue of responsibility for the preparation of country stabilization programmes must have been discussed repeatedly in the Fund.

The fundamental advantage of a country-prepared programme is that it would reflect its views on economic policy better than a mixed parentage, and it would represent its

58 The World Bank, *Financing Adjustment With Growth in Sub-Saharan Africa, 1986-90*, February 1986, p. 38.
59 As reported in *The New York Times*, 30 September 1986, following the interview.
60 Cleaver, *op. cit.*, p. 28.
61 Fund-Supported Programs, Fiscal Policy and Income Distribution, *op. cit.*, p. 3.

commitment to carry out the programme. According to the WIDER Tanzania study: "Since policy reforms are implemented by government, it is their commitment that will enable sustained adjustment effort. Purely "imported reforms" via conditionality alone will have limited effectiveness. Thus while using coordinated conditionality in aid disbursement to encourage change, the key initiative role has to remain with the concerned government. Informed dialogue rather than unilateral conditionality pressure from outside creates better political environment for adjustment internally."[62]

The second advantage of a nationally-generated programme is that it would lead to a country-specific treatment of the adjustment problem, adapted to individual circumstances. Dr. Frances Stewart, in a pioneering study proposing country-generated adjustment programmes, suggested that this may lead to a new typology of programmes:

While Fund conditionality tends to be rather stereotyped – a single model applied to most countries – it is likely that there should be a number of alternative models, incorporating special economic and political factors. It seems probable that different packages would be suitable for low-income countries with a strong manufacturing sector that has been inward-directed and for countries with outward-oriented manufacturing sectors. Other factors would be a country's size and political variables.[63]

The third advantage of nationally-formulated programmes is that they would be based on better information. As argued by Professor Kenen, "The Fund may have more experience than any government, but it cannot be expected to have more information. It may know more about the international economy because of its ability to gather and integrate information from many governments. It is not likely to know more about each national economy."[64]

The subject-matter coverage of nationally formulated adjustment programmes should not be expected to be much different from that under the present programmes – problems do not change because the procedure has changed – with one major

62 Benno J. Ndulu, *Stabilization and Adjustment Programmes in Tanzania 1978-1985*, WIDER, Helsinki, p. 24 (mimeo.). According to a senior World Bank official, "perhaps the most general conclusion that can be drawn from the Bank's experience to date is the importance of recipient's commitment to a particular course of reform for the ultimate success of the policy package." (Constantine Michalopoulos, *World Bank Programs for Adjustment and Growth*, Washington, D.C., February 1987, p. 33 (mimeo.)).

63 Frances Stewart, *Alternative Conditionality*, in SID/North-South Roundtable, *op. cit.*, p. 214.

64 Peter B. Kenen, *Financing, Adjustment and the International Monetary Fund*, The Brookings Institution, 1986, p. 49. The same point has been stressed by Professor Edmar L. Bacha.

additional element. The developing countries will normally insist on adjustment with growth and therefore on the integration of growth objectives in financial programmes. As argued by Dr. Buira:

> Developing countries in general attach greater weight to their development than do creditors. For them, the distinction between balance of payments and development finance is somewhat artificial, since they see the development of foreign exchange earning ability and the structural transformation of their economies as the means that will ultimately permit attaining a healthy and durable balance of payments position. The immediate objective of Fund programmes has been the correction of the balance of payments problems. Occasional references in programmes to growth rates are usually assumptions or forecasts rather than targets. In fact, growth objectives are not an integral part of the programme in the same way that balance of payments or fiscal objectives are. This points to a serious imbalance in the design of programmes... A Fund programme may integrate the growth objective by setting a positive global growth goal coupled with the external financing required to attain it.[65]

More generally, differences between the present and the nationally designed programmes will appear mostly in proposed remedies and policy instruments.

The majority of countries have sufficient staff to put together adjustment programmes suitable for discussion with external lenders. Some countries will probably need assistance. It could be provided by the lending agencies; by consultants; United Nations and UN Economic Commissions; or by a special advisory staff group which may be set up under the Chairman of the Group of 24 (developing countries) which operates within the Bretton Woods institutions or under the Chairman of the Group of 77 (developing countries) whose offices are at the United Nations. There may be yet other possibilities. It may also be possible to obtain UNDP support for this work. The benefits and costs of each solution should be considered further.

V 2 Agency Responsibilities

In assessing loan requests' and the associated country programmes, financial agencies have three main responsibilities: to assure, first, that borrowed funds will be used to promote economic growth and stability of the borrowing country; secondly, that loans will be serviced and repaid; and thirdly, that the broad interests of country membership as a whole –

65 Anel Buira, *Adjustment with Growth and the Role of the IMF*, 20 December 1986, pp. 16-17 (mimeo.).

increased world income, employment and trade – will be helped.

Mr. Sidney Dell, Dr. Stewart and Dr. John Williamson agree that there is a difference between what "the Fund has a right to insist on when it makes a loan – the assurance that a programme adequate to secure a payments turnaround will be implemented."[66] (*i.e.*, that the loan will be rapid) – and the use of "its unique lending position to impose a particular set of policies on borrowing countries, which it believes is good for them: this is what Sidney Dell has described as the 'grandmotherly' function."[67] The situation is probably similar with respect to World Bank's "structural adjustment loans", although full details are not yet available. Project and sector loans do not raise this problem for as long as they do not deal with economy-wide policy issues. There is no dispute about the repayment function and project sector conditionalities: it is agreed that they make possible for the financial institutions to discharge their responsibilities. The dispute is about the "grandomotherly function".

The financial agencies take greater risks than commercial lenders as they continue to lend when commercial lending has stopped, and they normally charge lower interest rates than the market despite the greater risks. These extra risks could be taken as a justification of the "grandmotherly function." In actual, and by now fairly long experience, the risks have proven small, however: most debtors have consistently given priority to servicing the agency loans, even at most difficult times. Under these circumstances, it is difficult to justify the "grandmotherly function" of the scope and depth it has obtained, particularly when there is a dispute concerning the economic theory on which substantial parts of this "function" rest.

Conditionality has two aspects: the need for orderly financial and administrative management, and changes in economic policy. The first aspect – orderly management – is indispensable under any circumstances and in any social and economic system. Included here are orderly tax administration and enforcement, tight public expenditure controls, realism of investment and financing plans, control over foreign borrowing, anti-corruption drives and enforcement, drives for accountability and sound

66 John Williamson, *The Lending Policies of the International Monetary Fund*, in John Williamson ed., *IMF Conditionality*, The Institute for International Economics, 1983, p. 632.
67 Stewart, *op. cit.*, pp. 201-202; Sidney Dell, *On being grandmotherly: the evolution of conditionality*, Essays in International Finance No. 144, Princeton, 1981.

management in public enterprises, stopping the use of government service to provide jobs, speed in decision-making and in the implementation of government decisions, policies to discourage, and measures to prevent, capital flight. The other aspect of conditionality – economic policy – is a matter which by its nature does not tolerate uniform treatment or a uniform doctrine or ideology. It affects income distribution, the strategy of resource allocation, the role of the government in economic life, the degree and the method of involvement in international trade, in short the essential philosophy of public policy. The interest of creditors in the economic policy of their debtors cannot be denied as it affects the service and safety of their claims. On the other hand, creditors cannot assume the role of makers of national policy in debtor countries: it is the political leaders of these countries which carry the responsibility for possible mistakes and pay for them with their jobs, and in extreme cases even with their heads.

A possible way out from this dilemma is to confine conditionality to factors bearing on debt servicing capacity and sound financial management, and at the same time institute a system of exchange of information, experiences and views on economic policy at regular intervals, on a consultative basis. Financial agencies would then have the opportunity to convey any concerns they may have, and debtors to present their views and expectations. Such consultative arrangements would preserve the beneficial aspects of the country-agency relationship, while reducing the frictions and confrontations. The high professional quality of the staff of the agencies and their enormous accumulated knowledge and experience would continue to be available to developing countries; the agency staff would continue to benefit from a first-hand exposure to reality in developing countries; and while it is only realistic to expect that problems in country-agency relations will continue to exist, perhaps the way of resolving them would be smoother.

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2 December 1987

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Dear Professor Oliver:

Enclosed please find a copy of my recently published study, Conditionality: Facts, Theory and Policy, in which you may be interested. I have taken the liberty of referring, on page 112, to your 1985 superb Bretton Woods: A Retrospective Essay.

Please accept my best wishes for the holidays.

Sincerely yours,

D Avramovic

Dragoslav Avramovic

Enclosure

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Conditionality: Facts, Theory and Policy Contribution to the Reconstruction of the International Financial System

I INTRODUCTION

ECONOMIC POLICY conditions accompanying loans granted by leading international agencies to developing countries have been a major point of dispute in North-South relations for a long time. Conditionality has been increasing in recent years, and this will raise the disputes to new heights. The roots of the controversy lie in the differences of views concerning, first, the substance of desirable economic policies in developing countries on some important issues, and second, the delimitation of the roles of the agencies and country governments in designing country policies. This paper suggests a possible way in which the controversy can be approached and eventually resolved.

Chapter II describes the present system of conditionality and its evolution. Chapter III discusses the strong points of conditionality. Chapter IV focusses on its weaknesses and on the controversial points of the theory of economic policy on which conditionality rests. Chapter V contains this paper's proposals.

II EVOLUTION

II 1 Present Situation

Four layers of conditionality are now practiced:

(a) Demand conditionality pioneered by the IMF through their monetary approach to the balance of payments. This focusses on cutting spending, primarily that of the government, currency devaluation, raising interest rates, and trade liberalization. There are now also elements of supply conditionality, mainly in eliminating price controls.

(b) Supply conditionality, pioneered by The World Bank, originally focussed on project (or micro) formulation and implementation, and dealing with pricing of products and

services to be sold by the project, and its management. This was then extended to cover sectors, and now, with "structural adjustment lending" to the entire economy. The centre of attention is the investment programme, system of incentives, pricing, financial liberalization, and trade liberalization.
(c) "Growth" conditionality, in application during the last year or so, focussed on giving a free hand and incentives to the private sector of the economy, including "privatization" of government-owned enterprises as much as possible, rationalization of the rest, promotion of of foreign direct investment, and again, trade liberalization.
(d) Cumulative total of (a), (b), and (c), called "cross-conditionality", where lending decisions of each agency depend on the borrower having met the loan conditions of some other agency. This is now in increasing use and it involves private as well as official lenders. [1] The breakdown in arrangements between a borrowing country and any one of these agencies – in particular the IMF and The World Bank – can have a "domino effect" in relations with all other agencies. [2] The situation is still fluid: the number of instances of "cross-conditionality" is increasing, but is not yet clear how firmly committed to coordinated action individual lenders feel they are. [3]

II 2 History

Conditionality did not exist in the original IMF Articles of Agreeemnt. The Fund started applying it since 1952, as a matter of a Board policy decision. [4] It has been spreading ever since. Professor Oliver, in a recent historical study, notes that "increasingly, beginning in the late 1950s, the staffs of the Fund and the Bank deeply concerned themselves with the internal economic affairs of their members, not infrequently in ways that induced headlines in the international press. These intrusions would have surprised the American delegation to Bretton Woods and would probably have infuriated the British, who regarded national economic sovereignty as an absolute, whatever might be

1 See Iqbal Gulati, *Aspects of Cross Conditionality*, Centre for Development Studies, Trivandrum, India, July 1986 (mimeo.).
2 Sidney Dell, *The Question of Cross Conditionalty*, June 1986, p. 23 (mimeo.).
3 In mid-November, The World Bank went ahead with a partial disbursement of a loan to Mexico, even though commercial banks had not yet approved their part of the loan package. (*The Washington Post*, 19 November 1986).
4 Sir Joseph Gold, *Conditionality*, IMF Pamphlet Series No. 31, IMF 1979, pp. 3-4.

agreed about plans for a Fund and a Bank." [5]

This is now history, relevant, but history; and we currently face a situation with a comprehensive net of conditionality, designed and implemented by a formidable international economic staff operating from powerful institutions. The number of issues they address in individual country programmes is increasing. This has led a prominent student to observe that we are now in the presence of a "Christmas tree" approach to conditionality, with new conditions being steadily added to the existing ones.

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III STRONG POINTS

Conditionality has contributed to policy evolution in developing countries in four areas, thus reinforcing the effects of lending agency financial contributions:

(a) Fiscal discipline;
(b) Export expansion;
(c) Proper management of public enterprises; and
(d) Alleviation of price distortions.

Each of these areas is discussed below.

III 1 Fiscal Discipline

Many problems facing developing countries – in their external accounts, domestic inflation, administrative controls, price distortions, and insufficient investment – have their origin in the fiscal imbalance. In mid-1980s, in Argentina, "the government was unable to finance the fiscal deficit without disorganizing the monetary side of the economy, driving the economy either to hyperinflation or overkill (due to the rise in interest rates)."[6] Argentina is an extreme case, but in different degrees the problem appears in very many places. A reduction in the fiscal deficit appears as one of the stabilization objectives in 86 out of 94 Fund-supported programmes during 1980-81, or 91% of the

5 Robert W. Oliver, Bretton Woods: A Retrospective Essay, *The California Seminar on International Security and Foreign Policy*, June 1985, p. 41.

6 Roberto Frenkel, Jose Maria Fanelli, Carlos Winograd, *Stabilization and Adjustment Programmes and Policies in Argentina*, CEDES-Buenos Aires and WIDER-Helsinki, August 1986, p. 43 (mimeo.).

cases.[7] There have been serious disagreements concerning the feasible speed and extent of the deficit reduction proposed by the Fund, the specific expenditure categories which the Fund has singled out for cutting, the nature of particular revenue increases it has proposed, and its tendency to shift the burden of adjustment to the public sector. But the general argument that restoration of fiscal discipline is a necessary condition for growth and self-reliance is valid. In countries suffering from hyperinflation, monetary stabilization may be a pre-condition for recovery of public revenue and thus for the reconstruction of public finances generally; but monetary stabilization will not be possible to sustain unless fiscal discipline is restored.

III 2 Export Expansion

Export expansion of manufactures now commands universal support. It provides for economies of scale: the larger the market in which one sells, the greater the possibilities of expanding production, perhaps at falling costs, and expanding sales, probably at unchanged prices, thus raising employment, income and profit margins and their mass. Furthermore, rising export earnings will help alleviate the foreign exchange constraint to growth – a critical issue in most developing countries. Questions have been raised concerning the effects on domestic small and medium intermediate goods producers of large exporters' free access to imported inputs (South Korea);[8] and there is apprehension that excessive export subsidies may lead to "fictive" exports and may have caused terms of trade deterioraton via reduced export prices (Turkey).[9] These are important qualifications, but they cannot eliminate the enormous advantages arising from a plentiful flow of foreign exchange, which provides room for maneuvering to domestic economic policy.

The World Bank and regional development banks have financed specific investment projects in export industries of developing countries for a long time, reflecting their conviction

7 Fund-Supported Programs, Fiscal Policy and Income Distribution, *A Study by the Fiscal Affairs Department of the International Monetary Fund*, September 1986, p. 33.

8 Alice H. Amsden, *Growth and Stabilization in Korea, 1982-84* WIDER, Helsinki, 1986, p. 6 (mimeo.).

9 Korkut Boratav, *Distribution, External Linkages and Growth under Orthodox Policies: The Turkish Economy in the Early 1980s*, University of Zimbabwe and WIDER, June 1986, pp. 26-27.