Economic Development Institute
of The World Bank

Economic Adjustment in Algeria, Egypt, Jordan, Morocco, Pakistan, Tunisia, and Turkey

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World Bank
Washington, D.C.

The Economic Development Institute (EDI) was established by the World Bank in 1955 to train officials concerned with development planning, policymaking, investment analysis, and project implementation in member developing countries. At present the substance of the EDI's work emphasizes macroeconomic and sectoral economic policy analysis. Through a variety of courses, seminars, and workshops, most of which are given overseas in cooperation with local institutions, the EDI seeks to sharpen analytical skills used in policy analysis and to broaden understanding of the experience of individual countries with economic development. In addition to furthering the EDI's pedagogical objectives, Policy Seminars provide forums for policymakers, academics, and Bank staff to exchange views on current development issues, proposals, and practices. Although the EDI's publications are designed to support its training activities, many are of interest to a much broader audience. EDI materials, including any findings, interpretations, and conclusions, are entirely those of the authors and should not be attributed in any manner to the World Bank, to its affiliated organizations, or to members of its Board of Executive Directors or the countries they represent.

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Foreword

This document is one of a series reporting on policy seminars organized by the Economic Development Institute of the World Bank. Policy seminars provide a forum for an informal exchange of ideas and experiences among policymakers from different countries, leading experts in development, and World Bank staff with respect to major issues of development policy.

Policy seminar reports focus on issues raised during seminars that may be of interest to a wider audience. They are not intended to be comprehensive proceedings. They seek, however, to convey the essence of the discussion that took place and to bring out any principal areas of agreement or disagreement that emerged among those participating.

Christopher R. Willoughby
Director
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Preface

The volume contains a summary report and four background papers for the Economic Development Institute's Senior Policy Seminar on Economic Adjustment in Europe, the Middle East, and North Africa, held in Izmir, Turkey, in collaboration with the World Bank's Europe, Middle East, and North Africa (EMENA) region. The summary report provides an account of the proceedings. The four papers examine the adjustment experiences of the participating countries: Algeria, Egypt, Jordan, Morocco, Pakistan, Turkey, and Tunisia.

Silva Lopes's paper, "Policies of Economic Adjustment to Correct External Imbalances," contains recipes for both short-term stabilization, which requires reduction of the balance of payments deficit and control of inflation, and medium-term structural adjustment to ensure adequate rates of economic growth and to prevent a resurgence of balance of payments problems. He argues that both rely on essentially the same basic policies. Growth of investment rather than of consumption should be encouraged; the efficiency of investment should be improved and adverse effects on income distribution should be avoided. But growth of investment requires savings and hence a reduction in current budgetary expenditures through cuts in public consumption, reductions in subsidies and current transfers, and an increase in tax revenues.

In the case of short-term stabilization, expenditure-switching policies contribute to reducing the severity of the demand restrictions that would otherwise be needed in order to achieve a given balance of payments target. It involves stimulating the production of tradable goods and changing the demand pattern in favor of nontradable goods. This is achieved through a depreciation of the exchange rate. The same applies in the case of medium-term structural adjustment. Countries that have had more success in their efforts towards adjustment are those that opened their economies by depreciating the real exchange rate, eliminating distortions created by import restrictions and export subsidies. But to avoid an inflationary impact of exchange rate depreciation, it is important to combine adjustment of the exchange rate with anti-inflationary demand management policies.

According to Silva Lopes, stimulation of exports is one of the main components of programs of economic adjustment. It involves correction of the bias against exports and relies basically on the adjustment of the real exchange rate and on import liberalization. Import liberalization should, however, be gradual. Adjustment also means liberalization of key prices—administered prices, wages, and interest rates. Complete elimination of price controls will not be easy to achieve in sectors dominated by monopolistic or oligopolistic structures, and the best solution in such cases is to introduce more competition. Governments may avoid undertaking adjustment because of the immediate political and social difficulties of adjustment measures, but in doing so they neglect the cost of postponing implementation of these measures.

Sweder van Wijnbergen's paper, "External Debt and the Public Sector: Towards Fiscal Policy for Sustainable Growth," looks into external debt and the formulation of domestic policies that allow sustainable growth within the limits of creditworthiness and macroeconomic stability. An important part of any program of internal adjustment is the extent of the public sector's contribution to improving the savings surplus. Typically, the fiscal deficit must be reduced, but its size has to be consistent with other macroeconomic targets for inflation and output growth. There are three ways of financing public expenditure beyond what can be obtained from the regular tax system—external borrowing, monetization, and the issue of domestic interest-bearing debt. Hence, in addition to the macroeconomic targets, the fiscal deficit has to be consistent with the constraints on debt issue implied by continued creditworthiness and solvency, which thereby impose restrictions on each financing method. Van Wijnbergen discusses whether these targets and constraints allow a

government to raise sufficient revenue to cover the deficit it has decided upon as part of its internal adjustment program. He then discusses the interactions between fiscal deficits and the macroeconomic variables upon which fiscal consistency hinges.

The paper draws on empirical work on Turkey to illustrate the trade-off between adjustments in fiscal policy and sustainable inflation. Van Wijnbergen discusses the impact on this trade-off of financial sector reform, economic growth, and real exchange rate policies and shows how the trade-off is affected by interest rates on foreign and domestic debt.

John Waterbury, in "The Political Management of Economic Adjustment and Reform," highlights the political costs of adjustment and suggests how to keep them to manageable proportions. The task of political management is coalition management. Every government has a set of allied interests and coalition partners, and any government that undertakes structural adjustment must calculate how the process will affect various members of the coalition. Structural adjustment often entails the dissolution or at least the realignment of a "populist" dominant coalition based on the military, the public sector, organized labor, and urban white-collar interests.

Waterbury outlines two phases of the adjustment program. In the first, with devaluation, deficit reduction through curtailed public investment, and de-indexation of wages are carried out. Measures taken in the second phase will include reducing consumer subsidies, freeing agricultural producer prices, lowering interest rates, increasing public investment, some deregulating of individual prices, reducing tariffs, and adjusting the exchange rate. The second phase benefits the agricultural sector and public enterprises that sell mainly to domestic markets which were streamlined in phase one but benefit from increased investment flows in the second phase. The two phases illustrate how the reform agenda can be compartmentalized so as to spread the burdens of adjustment and avoid harming the bulk of coalition members simultaneously. He suggests that progress towards reforms should be uneven, sometimes internally inconsistent, and, if possible, camouflaged. The higher the potential political and economic costs of structural adjustment, the greater the premium on obfuscation, and different kinds of subterfuge may be practiced.

Kemal Dervis discusses the supply reponse to the adjustment challenge in "Foreign Trade and Industrial Policy: Historical Perspective and Basic Policy Options." He discribes the industrial and trade policies that affect the industrial sectors in developing countries in general. Throughout the postwar period the structure of incentives favored activity oriented toward domestic markets and often discriminated severely against export industries. By the 1980s there was a need to generate an exportable surplus of manufactured goods in all the participating countries. But export industries had suffered from an anti-export bias of the incentive structure, which was reinforced by chronic overvaluation of exchange rates.

Studies have revealed that many industries suffered from negative protection while others received a very high level of protection. Correcting an anti-export bias involves duty drawbacks and other incentives. But the multitude of interventions leads to an incredibly complex and varied incentive structure: new measures are superimposed on older policies and it is difficult to trace the logic of intervention back to a well-defined and consistent set of government objectives. There are strong arguments for limiting the time span of incentives. The question remains as to the types of incentives that should be promoted. In the first model policymakers choose a limited number of sectors that appear promising at a particular stage of the country's development and concentrate their incentive policies on these sectors. In the second model policymakers do not try to pick the potential winners; rather they make incentive packages available to broad categories of new investments, encouraging "infant firms" and "infant activities" without trying to foresee which of the infants are likely to grow up fastest or spread the greatest amount of benefits. Experience has shown that the second model is safer in the end and is more effective in accelerating industrial growth. All such selective promotions work best against the background of an outward-looking economy with very moderate average protection and no general anti-export bias.

Most important, however, is the management, organization, and ownership of industrial enterprises which have to transmit price and incentive signals to the productive process. The quality of enterprise management is of utmost importance to policymakers in reforming those organizational or structural features of industry that inhibit efficiency-oriented management. In many developing countries large segments of industry are in the public sector. In Turkey, public industrial firms have made valuable contributions to the development process. But in most cases, they tend to face constant political interference and are pressured into uneconomic behavior, particularly in the area of employment. They then become large, weak bureaucratic organizations that do not transmit price and incentive signals to the productive sphere and are unable to generate the investable surplus necessary for continued growth. The rationalization and restructuring of these public enterprises are key priority areas for industrial policy.

1
Introduction

This paper summarizes the discussion which took place at the Senior Policy Seminar held in Izmir, Turkey, between 28 and 30 March 1988 on the subject of Economic Adjustment. This seminar provided the opportunity for an extended and open discussion between Ministers and senior officials from several member countries of the Europe, Middle East, and North Africa (EMENA) region of the World Bank, senior staff from the Bank, and a limited number of external resource persons. The EMENA countries that were represented were Algeria, Egypt, Jordan, Morocco, Pakistan, Tunisia, and Turkey. The World Bank staff were led by the regional Vice President of the EMENA region. The IMF was represented by Mr. Azizali F. Mohammed, Director, External Relations Department. The seminar was directed by Mr. Jayanta Roy of EDI and was moderated by M. Roger Chaufournier, former Vice President of the World Bank.

The purpose of the seminar was to provide a group of countries, all of which face the need for, and in some cases have implemented, economic adjustment programs, with the opportunity to discuss the design of these programs for their own particular circumstances, and to compare the perceived and actual difficulties of implementation. Though very different in many ways, the five countries of the Middle East and North Africa enjoyed very rapid economic expansion in the second half of the 1970s partly because of favorable commodity terms of trade associated with the boom in oil prices, and partly from high levels of receipts in the form of immigrant remittances. While Turkey was already facing serious economic difficulties in the late 1970s largely because of distortionary and inward-looking economic policies, the other countries represented at the seminar have begun to experience similar problems only in the more recent past. In particular, the decline in oil prices since 1985 has imposed major strains on the economies of Algeria, Egypt, and Tunisia while other countries such as Morocco and Jordan have been substantially affected by reductions in official remittances and/or in official grants from Arab oil-exporting countries. Thus, inspite of their differences, all the countries represented at the seminar have faced difficulties in their balance of payments as well as debt burdens which, in relation to several of the standard indicators of such burdens, are comparable with those of the more highly publicized debtor nations in Latin America.

The seminar proceedings were formally opened by Mr. Yusuf Ozal, Minister of State in the Turkish Government, who drew attention to the major ingredients of Turkey's own substantial program of economic adjustment. Thereafter, the seminar discussions were informed by four background papers prepared by World Bank staff and consultants namely Messrs. Jose Silva Lopes, John Waterbury, Kemal Dervis, and Sweder van Winjbergen; by presentations from all seven of the country delegations; and by a considered response to the points emerging in discussion made by the Bank's Regional Vice President. The synthesis of the main ideas included in these contributions as well as those made from the floor of the seminar is organized below into five further sections. Section II collects together certain ideas about the definition of the term "adjustment" and about the assessment of the effects of adjustment programs. Section III combines the discussion of two issues receiving extensive attention during the seminar namely the social aspects of economic adjustment programs and the possible need for a more explicit political analysis to support the design and implementation of these programs. Section IV examines the key question of the sustainability of adjustment programs in terms of several major influences on this including the internal consistency or otherwise of domestic policies. Section V relates this question of the sustainability of programs to the constraints coming from the world economic environment–an environment which several participants perceived as an increasingly hostile one. Finally, Section VI highlights some of the major concerns about the process of adjustment, and some areas of policy

design in most need of attention, as reflected in the concluding comments of the Bank's Regional Vice President.

2

Economic Adjustment

Definition, Content, and Assessment

Definition

There was a general acceptance in the seminar of the three-way classification of adjustment programs as proposed by Mr. Silva Lopes. The first of these is when adjustment to external payments difficulties is done in a *disorderly* fashion by resort to an intensification of import controls, increased reliance on administrative allocation of resources, and generally by way of interventionist policies designed to widen the gap between world and domestic prices. Several participants referred both to their own countries, use of such an approach and also to its ultimately unsustainable consequences. The second approach is the familiar short-term program supported by the IMF and involving the use of only a limited set of policy instruments mostly associated with demand deflation. The third is represented by the medium-term programs of the type increasingly supported by the World Bank which as well as involving a broad set of objectives, also embrace a potentially wide range of policy instruments.

There was little disagreement with Silva Lopes' proposition that the distinction between short-term stabilization programs and longer-term structural adjustment programs should not be overemphasized. This proposition has three main components. First, it is unlikely that countries confronted by serious macroeconomic imbalances can lay the foundation for medium-term programs of structural adjustment without a prior short-term effort to stabilize inflation and moderate external deficits. Second, several of the main policy instruments needed for these short-term stabilization efforts, including the exchange rate and interest rates, will also play an important role in the supply-side changes associated with structural adjustment. Third, several standard elements of the short-term stabilization package have revealed a tendency to be easily reversed, and such reversal may be less likely if they are embedded in a medium-term program of reform. This is not to say that there are no internal contradictions or that adjustment programs which attempt to change the structure of economic activity on the basis of a prior deflation of demand are guaranteed to succeed. Many participants referred to the practical difficulties, relating both to domestic political pressures and to international economic constraints, of initiating structural adjustment from a basis of demand inflation. However, there was no serious questioning of the proposition that the sound design and implementation of these two complementary aspects of adjustment could bring success, especially where sustained political commitment and favorable external conditions enabled the medium- and longer-term benefits of major policy changes to be realized rather than to be aborted prematurely. From this point of view, there was considerable interest on the part of those countries which are just embarking on adjustment programs in the experiences of Turkey where an adjustment philosophy has been maintained over almost a decade, and especially in the lessons to be replicated and the mistakes to be avoided.

Content

As regards the nature of the longer-term adjustment itself, there was a widespread recognition that this involved fundamental changes in pre-existing patterns of resource allocation. Equally it was generally accepted that the policies favored by most developing countries in the 1960s and 1970s had encouraged a pattern of resource allocation which was often unsustainable in the sense that

implicit or explicit subsidy would be required to keep large parts of the productive system in operation. Especially in the late 1970s and early 1980s, these policy errors had been exacerbated by violent shifts in international circumstances which had confounded the price and/or demand assumptions upon which major public and private sector investment decisions had been based. While no government, whether in the developed or developing countries, was immune from the temptation to use policy interventions to insulate key sectors from the consequences of these errors, few had the financial resources to do so on a large scale. Furthermore the economic arguments for so doing were normally flimsy.

Although the seminar made no attempt to comprehensively define the content of adjustment programs, some discussion of this issue did occur. In particular, while several participants manifested a deep anxiety about the unfavorable world institutional and economic conditions in which this had to take place (see Section V below), most accepted that the appropriate resource reallocation would be one giving greater prominence to tradable goods production and less to nontradable. This in turn would involve a movement of relative prices in favor of tradable goods. The paper by Mr. Dervis presented a critique of the anti-export bias of the trade policies followed until the last few years by most of the countries represented at the seminar and drew attention to three of the main components of reform. The first is to moderate the implicit taxation (negative protection) of export activity which is an inevitable but often unintended by-product of high import protection. This can be done either by lowering import protection or through mechanisms which diffuse the effects of protection by explicit or implicit export subsidies. It was noted that notwithstanding substantial reductions in the anti-export bias of policies in Turkey, Morocco, Tunisia, Egypt, and Pakistan in the recent past, some degree of bias still exists in all countries except perhaps in Turkey. The second is to follow up the major reductions in both the maximum levels and the ranges of tariff rates, which has already occurred in most of the countries represented in the seminar, by correspondingly improved order, rationality, and simplicity in other aspects of industrial protection and support policies. This suggestion is based on the proposition that in highly complex systems of intervention, the *net* effects of policies are hard to identify and it is correspondingly difficult to say whether the basic objectives of intervention are being realized or not. The third is to maintain greater discipline in placing time limitations on those aspects of industrial promotion which are legitimately justified in the short-term by market failures or externalities. Rules for temporary supports need to be more clearly defined and the benefits they provide need to be carefully weighed against the effects they may have in undermining the credibility of the main thrust of a government's industrial strategy.

A number of comments were made which qualified or criticized certain aspects of the standard World Bank package of adjustment measures. One commentator referred to the failure of the approach to recognize that many of the immediate motivating factors necessitating adjustment lay much more in external factors, beyond the control of the countries themselves, than in failures of domestic policy. Hence cures ought to be more clearly attuned to causes and not prescribed in general terms irrespective of causes. Several participants gave partial endorsement to this by noting the destabilizing influence on their own economies of the recent volatility of the values of key currencies and particularly the influences of this on the balance between export earnings and import values and the magnitude of debt ratios (see also Section V below). However, the practical implications of the suggestion of tailoring solutions to causes were not explored and it was not clear how much support this idea commanded in the seminar. There was clear support however for a proposition emanating from the comment that an important factor in Turkey's successful adjustment had been the serious efforts to build and restructure export industries in advance of a fully-fledged liberalization of imports. Participants were critical that this was not done more widely in Bank-supported programs but, in a more positive spirit, were anxious to explore ways in which to design

policies to strengthen relevant parts of the productive sectors as a complementary step to exposing them to the full forces of international competition.

Assessment of Programs

As noted earlier, several of the participating countries at the seminar have embarked on adjustment programs only relatively recently and as yet a full assessment of the degree of success of such programs is not possible. However, the newly adjusting countries were able to report generally encouraging results thus far. In the case of Tunisia for example, it was reported that the adjustment measures so far implemented had resulted in the reduction in the fiscal deficit from the 8 percent of GDP recorded in 1984 to only 3.6 percent in 1987. This had been achieved with a growth rate which had accelerated to 5.8 percent in 1987 and a growth rate of exports which had attained a level of 14 percent in the same year. The higher growth rate had been achieved inspite of reduced government expenditure. Furthermore, inspite of far lower import protection, the growth rate of imports had slowed down in 1987. Similarly in Morocco an adjustment program centered on a gradual liberalization of imports has resulted in the external deficit declining from some 13 percent of GDP in 1982 to little more than 1 percent in 1987. Meanwhile the fiscal deficit has halved relative to GDP and the coverage of the import bill by exports has risen from 48 percent in 1982 to almost 69 percent in 1987.

Two main qualifying comments were made about interpreting evidence of this type as proof of the success of adjustment programs. First of all it was noted that most of the middle-income European, Middle Eastern, and North African economies are characterized by an implicitly high degree of international capital mobility even though explicit capital controls are still widely applied. This paradox is explained by the large capital movements which can occur in the guise of migrant remittances and through devices such as the over or underinvoicing of imports and exports. Since these movements are known to be highly sensitive to exchange rates, interest rates, and other policies featuring prominently in the early stages of an adjustment program, it is not surprising that the correct setting of these policy instruments can result in a very rapid effect on the *measured* performance of the economy. While this may lead to the greater transparency of trade when improved trade policies remove the incentives for smuggling, it is not necessarily indicative of adjustment in the sense defined earlier as a major reorientation in the structure of production. This takes longer, probably requires major new investment, and certainly requires the sustaining of a policy commitment and the credibility of policies over a long period of time. Turkey is the only one of the countries represented at the seminar where the length of the adjustment experience has been sufficient to provide unambiguous evidence of success in this sense.

The second comment was made by the representatives of several of the newly adjusting countries themselves and is indicative of the types of problems which they still face. In the case of Tunisia for example it was noted that the adjustment program had created shock waves in the system with an estimated 500 productive sector enterprises, accounting for some 20,000 jobs, finding themselves in financial difficulties. The negative effects of reduced protection on the productive system had been quick to arise whereas the positive response of production to the enhanced profitability of, for example, export activity had been disappointingly slow. Hence the incipient employment consequences of the current situation were extremely disturbing and could easily lead to the aborting of some of the desirable features of the adjustment program. Several other participants echoed this concern and in the process drew attention to the difficulties of establishing a broad-based belief in the permanence of a new system of institutions and incentives when the previous system had become so firmly ensconced with many jobs and other vested interests dependent upon it.

3

Social Dimensions and Politics

It was common ground in the discussion that the attempt to achieve a major reallocation of productive resources—often from a highly distorted starting point—will inevitably cause losses and economic hardship to certain sections of society. Recognizing that there is no adjustment unless some losses occur to some groups, it was nevertheless useful to notice that there are *two* distinct categories of losers which ought to elicit two quite separate types of reactions from the government.

First of all the losses to the poor or vulnerable groups in society which, since the improved position of such groups represents one of the central objectives of economic development, need to be given serious attention and, to the extent possible, moderated. In relation to the first group, while there is no clearly established analytical link between adjustment programs and the living standards of the poor and the vulnerable, there is a widespread perception—fully reflected in the seminar discussion—that this group will suffer to an unacceptable degree. This is most likely to occur because the short-run reductions in real income and consumption associated with demand deflation are unlikely to bypass the poor, but it may also occur because the longer-term improvements in economic productive activity may not dispense proportionate benefits to such groups. [However, it was also noted that the worst thing that could happen to the poor is that economic policies are operated in such a way that a major recession is ultimately an unavoidable consequence.] Although not the subject of concerted discussion in the course of the seminar, participants were provided with copies of the recent World Bank booklet entitled *The Alleviation of Poverty Under Structural Adjustment*. This draws attention to four classes of ways in which the design of adjustment programs can help to alleviate the poverty effects by giving explicit attention to improving the "primary" claims which the poor acquire from their participation in the production and accumulation processes. It also notes some of the compensation mechanisms which can provide various forms of transfer to augment the primary income and consumption of the poor. The central message, which was also reiterated in the concluding remarks of the Regional Vice President, is that we now have a reasonable understanding of how to design adjustment programs in ways which can moderate the possible negative effects on the poor but more needs to be done and there has to be a major role for public investment and other public expenditures.

The second group of losers are those who have drawn incomes by virtue of access to scarce import licenses, by exploiting the scarcities implicit in systems of price controls or in various other ways by participating in the non-productive activities made possible by a distorted rent-seeking economy. Since the pre-adjustment incomes of such groups are often extremely high while their contribution to economic progress is negligible, there was no real disagreement that the losses which adjustment imposes on them are legitimate and even desirable. Nonetheless, since members of this second group may constitute powerful vested interests wielding significant political influence, many contributors expressed sympathy with some of the propositions in the paper by Mr. Waterbury which argued for a more explicit political analysis of the adjustment program designed, among other things, to find ways of steering around and moderating the obstructive influences of those main vested interests.

There were two main themes in Waterbury's paper which received close attention during the discussion. The first was that, in the process of building and sustaining the consensus needed to carry through major economic reform programs, it may be useful to monitor the gains and the losses and even to deviate somewhat from the ideal design of the economic program in the interest of keeping enough of a coalition in place to complete the task. The presumption underlying this first theme, and one which received little challenge, is that the typical economist-designer of adjustment

programs often has insufficient insight "into how to govern and administer development policy in political environments in which consensus may at best be embryonic and instability a fact of life." While the subject of the political management of structural adjustment is presently more of an art than a science, there was a recognition among some seminar participants of the importance of giving this subject greater prominence. Others expressed skepticism about whether there was a real reconciliation to be found as between the financial/technical/efficiency questions associated with economic adjustment, and the major political arguments as between, for example, socialism, capitalism, and Islamic fundamentalism with which Egypt and other countries in the region need to deal.

The Turkish participants drew attention to some of the political devices which had helped to win the acceptance of potentially unpopular economic policy changes in their country. One example was the establishment of Public Participation Funds in activities such as electricity distribution and the management of the Bosporus Bridge as one way of gaining support for the realistic pricing of such services. Another was the use of Extra-Budgetary Funds generated through expenditures on infrastructure. Equally it was argued that the privatization of certain activities had enabled the government to act more independently in its economic policy than had been the case when it was also a more substantial participant in the productive sector.

A second theme from the Waterbury paper which generated considerable controversy was that, in some circumstances, it may be useful for a government to indulge in a degree of obfuscation of its policy intentions and actions in order to limit political responses which might otherwise abort these. It was accepted that there were cases where politicians needed to be less than frank about their intended policy actions—a future exchange rate devaluation was the best example. Thereafter, participants were able to refer both to cases where absolute honesty about economic policy intentions had served some politicians extremely well, and to others where absolute frankness had been little short of disastrous.

In the end a useful and generally acceptable operations guideline from this part of the discussion can be elicited by noting the following. There is little dispute that successful adjustment (from an often highly distorted situation) would need a long-term vision of the future and *clear signals* to persuade economic agents to change modes of production and behavior from the patterns established, in some cases, over decades. But these very clear and unambiguous signals probably need to relate to only a limited sub-set of policies. Two in particular were stressed. The first is the signal to exporters that they will enjoy in the long-term an incentive and profit margin which on average is not adverse compared to the incentives available for supplying the domestic market (a point stressed in the Dervis paper). The second was a signal to all agents that external balance targets and associated exchange rate policies will remain fully consistent with the fiscal balance of the government and/or its stance of policies to support a private sector savings surplus (a point stressed in the van Wijnbergen paper). The counter case of Argentina where this was not done was mentioned several times. Once signals in these limited areas are clearly set and have gained credibility, there is scope for governments to indulge in some changes of mind and even obfuscation of detailed aspects of their policies without doing damage to the underlying thrust of adjustment. Both South Korea and Turkey testify to the false starts and errors of policy that can be accommodated behind an unambiguous commitment to reform in a few key areas. In particular, if there are agents who need to receive signals which they are likely to regard as unpalatable there may be a good political argument in masking these signals so as to limit the political resistance and the possible damage to the reform program which might otherwise arise.

4
Sustainability of Adjustment

A major theme running through the two days of the seminar was the inherent difficulties of sustaining adjustment and the wide range of factors which could compromise its success. These factors are discussed here under two main headings. A third factor, namely the need for an assured stream of external financing to underwrite adjustment policies, is discussed together with other aspects of the international environment in Chapter 5 .

The Internal Consistency of Policies and Sequencing

Only brief reference was made to the debate about the right sequence in which to liberalize the current and capital accounts. Silva Lopes referred to faulty design as one of the three main factors which could abort adjustment programs (the others being lack of persistence and unfavorable external shocks), and in this context referred to the failures of economic reform in the Southern Cone economies of Latin America associated with the prior liberalization of the capital account. It seemed to be common ground that the countries represented at the seminar could not seriously contemplate any early liberalization of their capital accounts especially since most still had to overcome the problems of limited, inefficient, and highly administered domestic financial markets. The Algerian participants, in particular, referred to the need to avoid the Latin American problem of allowing exchange rate policies to generate strong speculative pressures which could abort their intended effects on improved resource allocation.

There was considerable interest in the issues of the internal consistency of policy brought out in the paper and the presentation by Mr. van Wijnbergen. The first of these issues related to the need for consistency between the fiscal deficit of the government and the target for the external account set by the adjustment program. The central point here is that for a given revenue from internal and external debt issues (see the next point below), the total revenue available to the government will be directly but negatively affected by its success in reducing inflation since this success will reduce the revenues from the inflation tax and seigniorage. The example of Turkey suggests a high degree of sensitivity of these revenues to changes in the inflation rate. The main policy message from this analysis is that adjustment programs which include inflation reduction as a main component need to incorporate explicit fiscal arrangements to replace the revenues lost as a result of lower inflation. The failure to do so means that the program itself may fail because of the inability to achieve fiscal targets which are consistent with external balance of payment targets.

However, should the improvement in the government's own savings surplus (i.e. Sg-Ig) be *insufficient* to match the target for the non-interest current account (i.e. X-M), then the situation might still be resolved if an improved private savings surplus (i.e. Sp-Ip) could be achieved. Further it was argued that this could indeed be achieved by a policy of high real interest rates such as that adopted in Turkey. Although the effects of high real interest rates on Sp were ambiguous they would if anything be positive while the effects on Ip would be negative. Excessive negative effects on Ip—and so on the long-term sustainability of the adjustment program—could best be avoided by active use of strong global or selective investment incentives.

This latter set of propositions caused some dispute and involved the general question of how sustainable the Turkish program of adjustment really is given the high interest rates and the adverse effects this possibly has, notwithstanding investment incentives, on the actual level of investment. Some Turkish participants referred to the excessive encouragement of house building in the present incentives regime. More generally it was observed that investment incentives should not provide

undue selective support to investment in nontradable goods sectors. If this were to be done, then the clear and unambiguous signals about the priority of tradable goods production would be seriously compromised.

It was also observed that enhanced investment during adjustment programs was generally needed to increase or improve capacity and not so much to help produce a Keynesian stimulus through enlarged aggregate demand. In other contexts, Tunisian and other participants drew attention to the heavy indebtedness and financial distress of large parts of the productive system of their respective countries. The overhang of extensive internal debt could be a factor compromising the success of a high interest rate policy because it could certainly endanger the financial stability of low return and loss-making industries for which the new higher borrowing costs will exceed the real return on investment, and for which most forms of investment incentive will provide only negligible compensation.

One other participant observed that internal debt problems were just as likely to cause the aborting of adjustment programs as were the problems of external debt. Since these complex matters were discussed only very briefly during the seminar, attention is drawn to the far more extensive discussion they received during the July 1987 EDI seminar on Managing Financial Adjustment in Countries of Europe, the Middle East, and North Africa.

The second issue pertaining to the internal consistency of policies brought out by van Wijnbergen related to the uncomfortable realities, based largely on economic arithmetic (accounting identities), linking current account, debt, and growth targets. This was based on the fact that the following four factors' impact on a country's ratio of external debt to output was felt in a predictable way and in the directions indicated below:

	Effect on Debt/Output Ratio
Non-interest Current Account Surplus	Negative
Growth Rate of GDP	Negative
Real Interest Rate on Foreign Debt	Positive
Real Devaluation	Positive

The Algebraic derivation of the effects reflected in this listing is fully described in van Wijnbergen's paper. In brief, the mechanism is as follows: other things being equal, a positive non-interest current account surplus will enable a repayment of debt and so a reduction in the debt/GDP ratio. Similarly, a high rate of GDP growth, other things being equal, will ensure a reduction in that ratio. However, for a given initial level of debt and a given growth rate of GDP in local currency terms, an increased real interest rate on debt will raise the debt/GDP ratio by necessitating increased borrowing to service existing debt. This has two components. The first is the nominal interest rate on debt and the second is the international price index of the goods a country sells relative to those it buys. If this index declines then, other things being equal, the debt/GDP ratio will rise because more resources (in local currency terms) need to be mobilized to achieve any given export-import balance. Finally, since the debt/GDP ratio is measured in local currency terms, it will be increased, other things being equal, every time there is a *real* devaluation of the local currency. When these ideas are combined, it can be shown that the debt/GDP ratio cannot decline if the economy's growth rate is lower than the real interest rate on debt. However, if the growth rate exceeds the real interest rate by a sufficiently large amount, the debt/GDP ratio can decline for any given non-interest current account surplus provided that the real devaluation effects on debt are not too large.

From this it can be noted that a policy of regular real devaluations of the type adopted in many adjustment programs, including that in Turkey, imply the need for a rapid growth of output if an economy is going to achieve stability or a decline in its debt/output ratio consistently with any given target for its non-interest current account balance. Similarly, if a country is shocked by a higher real interest rate on debt either because of higher nominal interest rates or a decline in the world price of its output, then the task of stabilizing the debt/output ratio will be harder for any given targets and values for the other factors listed above.

The proposition was debated mostly in relation to Turkey where high export growth rates encouraged by sustained real devaluations have brought debt/export ratios *down* during the 1980s although growth rates, inspite of being rapid, have not been sufficient to prevent a substantial rise in the debt/output ratio. It was noted how much better Turkish growth performance based on this strategy had been relative to other highly indebted countries which have given greater priority to achieving large current surpluses. However, it was also argued by several of the Turkish participants that Turkey was ill-advised to allow the debt/output ratio to rise much higher than its present 58 percent. The implication drawn from this was that future Turkish policy would need to place more emphasis on selling exports through quality, implying technological upgrading, improved quality control etc., rather than through competitive pricing alone. Hence the consequences of the unpleasant arithmetic could be circumnavigated by limiting the future size of real devaluations provided that appropriate new policies could be put in place to achieve the necessary upgrading of products.

Real Resource Allocation and the Transition

Although this was not a subject which received systematic attention, there was a recurring concern among participants that changes in incentive policies of the type which are standard in adjustment programs and were advocated in the Dervis paper were necessary but not in themselves sufficient to bring about the major resource reallocation implied by adjustment. Although the implications gave rise to misgivings in some quarters, there was considerable sympathy with the Tunisian viewpoint that governments could not stand by and watch large elements of their productive systems being dismantled because of an inability to compete effectively in a newly liberalized environment. There was a need, it was argued, for a more pro-active role on the part of organizations like the World Bank to help restructure at least major industries to enable them to survive the consequences of liberalization. Because of the inherent difficulties which Jordanian and other contributors argued they faced in liberalizing in the face of non-neutral trading policies in neighboring countries, there was a need for some tailoring of the standard approaches to improving certain policies. Possibly one answer to this was for the World Bank to take more note of the regional context of reform programs and, from time to time, play a promotional role in regional projects and regionally focused restructuring.

A central element in this discussion was the role and behavior of labor markets. Contrary to much accepted economic theory which assumes a relatively rapid movement of labor in response to new incentive structures, the reality perceived by most speakers was one in which deep-seated expectations and severe rigidities in labor markets would give rise to increased unemployment as one of the early consequences of adjustment. In the Tunisian case for example, there is a need to find work for more than 80,000 new recruits per annum in addition to those released from activities in decline. There is no immediate sign that the adjustment program can deliver this. In Turkey the magnitude of the labor market problem is very much larger. The Jordanian participants drew attention to outward migration as one temporary solution to this problem but they also argued that this was not sustainable in the longer term. In Jordan, efforts have been made since 1985 to involve the labor market more centrally and explicitly in the design of the adjustment program. This has

involved far more attention to vocational training, better internal coordination to match available skills to jobs, and above all, a priority to the service sector as a leading sector in relation both to adjustment and to development more generally. The logic here is not only that service sectors are labor-intensive while manufacturing industries face considerable problems in breaking into protected international markets, it is also that the absence of supporting services is one of the major bottlenecks confronting an improved performance in the manufacturing industries themselves. There was broad agreement that this suggestion for an enhanced role for service industries would justify serious consideration in other countries.

Finally, the World Bank participants drew attention to two of the more important factors which condition the severity of the transition difficulties of adjustment. First, if distortions are large, perhaps because they have been sustained by supportive policies for a long period of time, the strength of the vested interests against their removal and the transition problems more generally are also likely to be large. One example would be where artificially low energy prices have encouraged the establishment of productive activities whose profitability is dependent on such prices. Another would be where investments based on erroneous policy signals have locked in a high volume of non-performing loans in the banking system. Second, in relation to manufacturing production, it was argued that the transition difficulties are likely to be far greater in middle-income countries where industry accounts for a significant part of total output than in Africa and other less industrialized regions. The automobile industry of the Ivory Coast was mentioned as an example where the closure of capacity had not generated insuperable social or political difficulties because the absolute size of the employment and capacity loss was relatively modest.

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The World Economic Environment

Almost every session of the conference generated some comment or criticism about the adequacy of the current world economic environment as a suitable context in which to undertake successful adjustment. At the highest level of difficulty, a contrast was drawn between on the one hand the strenuous efforts of many developing countries to adjust their economies with, on the other, the largely passive and even complacent attitude of certain major developed countries regarding their own macroeconomic difficulties. In addition it was argued that the absence of coordination in relation to most aspects of policy on the part of the developed countries was resulting in chaotic movements in exchange rates which was extremely damaging to developing countries. It was not unusual, for example, as the Algerian participants noted, for short-term swings in exchange rates to generate larger movements in debt positions or in export earnings than anything which could reasonably result from strenuous adjustment. The seminar discussion itself made no serious effort to define the operational consequences for global international policy of these undeniably adverse elements of the present situation. In broad terms however, it was accepted that the countries present needed to make the best of the present world environment and could not be advised to use it as an excuse for delaying their own reform.

This having been said however, a number of themes emerged where there was equally strong criticism of the present global situation but somewhat with more prospects of operational improvements in present arrangements.

Debt Problems and the Adequacy of Financing

Several participants pointed out that the limited volume of international capital transfers represents a potentially serious constraint on what can be achieved through adjustment programs. Tunisian and other contributors expressed their serious concern that with so many countries attempting adjustment programs simultaneously, the "headroom" provided by available financial transfers is likely to be insufficient to ensure widespread success. There was in particular the concern that the World Bank itself was unable to make the medium-term advance commitments of SAL funds to ensure that a sustained effort at adjustment could be underwritten. In an environment of considerable uncertainty, it was suggested that countries do need some forms of guarantees if they are to be asked to accept the very high costs of embarking upon adjustment.

These comments were given some statistical substance through the contribution made by Mr. Parvez Hasan. He noted that for many of the conventional debt indicators, the position of several of the EMENA countries was worse than that of heavily indebted countries such as Mexico, Argentina, and Brazil. The interest payments ratios, for example, were particularly high in Morocco, Egypt, Turkey, and Jordan and in some cases as much as 20-25 percent of domestic saving was being transferred abroad in this way. It was widely recognized that the danger of underfunding of adjustment programs was very real in the worst of these cases. But the paradox is that the availability of adequate finance depends at least in part on sound adjustment programs and, as Hasan noted, "The burden of external debt will remain a major constraint on growth in EMENA in the foreseeable future, and it will not be easy to put the financing packages together which will ensure at least a minimum of orderly growth and gradual improvement in debt indicators without strong domestic adjustment efforts."

He further noted, following the logic in the van Wijnbergen paper, that the scope for additional future borrowing consistent with improved creditworthiness (i.e. lower debt ratios) will depend

upon three main variables: (i) the real rate of interest; (ii) the growth rate of exports; and (iii) the growth rate of GDP. Many countries are clearly pessimistic about the prospects for a lower real rate of interest because of doubts about the likelihood of a recovery of the prices of their main exports, and/or doubts about the availability of low interest finance or their ability to achieve more concessional terms on existing debt. In these cases, the growth rate of exports and GDP will have to be relatively rapid in order to justify large additional borrowings. But in the near future, the growth rates of both GDP and exports may well be held down because, Algeria aside, the countries at the seminar have achieved only modest investment/GDP ratios in the recent past. They also face ongoing difficulties associated with a weak international economy. Thus the essence of the structural adjustment in many countries is to improve the efficiency with which economic resources are used so as to achieve satisfactory growth rates of GDP notwithstanding limited growth in investment.

It was suggested that because of the need to reduce the debt overhang, and to make large interest payments, the non-interest current account balance of payments was likely to move into surplus in almost all the EMENA countries by the mid 1990s. Though this will mean that the net capital transfer to the region will become substantially negative, the gross borrowing requirement will remain large. On the basis of relatively realistic assumptions, this gross borrowing is likely to amount to $18.5 billion by 1990 for the seven countries represented at the seminar.

Exchange Rate Uncertainty

The chaotic movement of the relative values of key exchange rates was widely referred to as a factor compromising the probable successes of adjustment programs. This had two main aspects. The first is the concern that more should be done in the major industrial countries to achieve coordination of exchange rate policies. The second is the concern that the attempt to achieve real devaluation simultaneously in a large number of developing countries was ultimately a competitive and self-defeating process. Not surprisingly, the seminar did not reach substantive conclusions regarding these two issues—they were merely flagged as matters of great concern.

The contribution of Hasan further noted that for several of the countries represented at the seminar, the non-interest current account balance of payments was generally in deficit in the period 1982-87. In those countries where overvalued exchange rates were a contributory factor behind these deficits, adjustment towards equilibrium would generate an inevitable rise in debt/GDP ratios because of the necessity of real devaluations as a component of this adjustment.

Furthermore, the experience of 1986 and 1987 had been such that only a small percentage of the increase in debt outstanding of the seven countries had been due to new net inflows. The balance had been due to a decline in the value of the US dollar. Many of the countries in EMENA now have debts which are substantially denominated in DM, Yen etc. (in Turkey, for example, 40 percent of non-dollar debts are now in the three main non-dollar currencies), while exports are still heavily denominated in dollars (oil is the obvious main example). For any country where the extent to which exports are denominated in dollars exceeds the ratio of dollars in total debt, a decline in the value of the US dollar will increase the ratio of debt/exports. Although several participants bemoaned the fact that this had happened in the recent past, it was also noted that there was considerable scope for management of the currency composition of a country's borrowing to limit the effects of future exchange rate fluctuation. Mr. van Wijnbergen for example, noted that while the formulation of specific mechanical rules awaited the results of ongoing research, intuition readily suggested the direction in which these rules are likely to point. Specifically, it was probably unwise for a country to maintain a close match between the country and the currency structure of its trade deficits and the currency composition of its debts. For example, a country having a large bilateral trade deficit with Japan should probably avoid having too large a share of its external debt

denominated in Yen. Furthermore, countries such as Algeria where the terms of trade were dominated by movements in the price of a single commodity such as oil, there was a strong argument for giving serious consideration to issuing debt indexed to the price of oil even though this would be nominally more expensive. In these and other ways countries could achieve some degree of hedging against the risks of currency fluctuations to which they are otherwise fully exposed.

Trade Barriers and Export Prospects

Several participants questioned the wisdom of policies based on more liberal trade and greater emphasis to exports when potential trading partners were themselves guilty of protectionism and the widespread use of distortionary government intervention. The Moroccan and Jordanian contributors in particular noted that it is impossible to find a neutral incentive system for trade anywhere in the world and developing countries could hardly be expected to implement such an idealized system. In the Jordanian case in particular, the implementation of a neutral trading system was rendered extremely difficult by the patently non-neutral stance of policies in neighboring countries. It was further noted that adjustment policies are often implemented when the balance of payments is under most severe pressure. Advice to the effect that a country should liberalize trade and import *more* at such times was unhelpful and was certainly perceived to be impractical by many governments.

While there was some sympathy in general terms with these propositions, it was not entirely clear what they implied in practical terms. Some of the World Bank contributors drew attention to the major costs which countries imposed upon themselves by persisting with protectionist policies. Others noted that inspite of the apparent unfairness of the world economic system, there was nothing to be gained by merely deploring the situation and using it as an excuse for retaining manifestly unsatisfactory policies. Some developing countries had forged ahead and made major incursions into world export markets in spite of having to overcome serious protectionist barriers in many of the main markets. Attention was drawn in particular to the major contrast in the export performance of Pakistan and South Korea: the former having expanded exports in dollar terms by 5 times since 1964 as compared to an expansion of 350 times by the latter. Finally, there was some sympathy for the proposition advanced by the Egyptian participant that the World Bank when formulating trade policies ought to give rather more attention to the regional context in which several of the countries at the seminar operated, and not regard countries as independent of each other in their trade.

6
Summing Up

In his summing up of the seminar proceedings, the Regional Vice President attempted to respond to the major concerns about the adjustment process as reflected in the comments from participants. In doing so, he conceded that many of the challenges of adjustment still have to be faced and that there remain several gaps in the design of adjustment programs.

As regards the *Definition of Adjustment,* he rejected the notion that it can be regarded merely as a belt-tightening exercise. Nor can it be regarded merely as a re-balancing of a country's accounts. While imbalances in the books might act as the crisis which triggers adjustment, adjustment itself is a process which captures the very essence of development—a reform process to better organize the allocation of a country's resources to achieve a better life for citizens of the country generally. There were several choices available to countries in implementing this process and it had to be accepted that senior Ministers had the knowledge and the responsibility to make decisions about the relative merits of the various possibilities. It was not the role of the World Bank to preach to the decisionmakers but rather be available to provide technical support and advice about the *hows* of adjustment.

As regards the *Social Costs of Adjustment,* he noted that anyone who wanted a full set of safeguards to eliminate such costs would be disappointed. Adjustment necessarily implied that there had to be some losers. Furthermore, the losses which some groups had sustained in adjustment programs so far had been large by any standards. In the Ivory Coast, for example, the average loss to urban household groups had exceeded the average 25 percent loss of real income in the USA and West Europe during the Great Depression of the 1930s. While this was the price which had to be paid for unwinding long-lived distortions, the offsetting benefits were worth achieving. In the Ivory Coast, for example, there had been an observable increase in agricultural output and incomes even after a period of only two years.

He recognized that measures need to be taken to protect the living standards of the poorer segments of the population during adjustment. In most countries such groups could not be expected to constitute an effective political lobby to defend their own interests. He drew attention to some of the recent thinking of the World Bank in relation to this problem and in particular to the task force on 'Protecting the Poor during Periods of Adjustment' which, among other things had proposed a fund of $1 billion for various measures designated to raise the productivity of the poor during the adjustment process. There was also a major initiative focused on Sub-Saharan Africa, to better document the precise manner in which particular socio-economic groups might be harmed or benefited by particular components of adjustment programs. These various efforts were all designed to achieve greater sensitivity in the design of adjustment programs as regards their impact on the poor. On the question of how the composition of lending might be tailored to better serve the needs of the poor, he recognized that the Bank did need to raise the volume of lending directed at the social sectors. There was also scope for more attention to public expenditure reviews and also to the provision of adjustment funds to support the implementation of programs of public sector retrenchment from some activities, so as to enable fuller and more efficient resourcing of the important social services.

On the question of the *Adjustment Transition,* he conceded with the argument made by several contributors that we probably do need to go rather more slowly in pursuing total liberalization. The idea of attempting to strengthen export sectors in advance of a fully-fledged freeing of imports was also something that he was happy to endorse. However, he acknowledged that the idea that governments should intervene to try to restructure their productive sectors more generally was one

which frightened him. In part this was because there were just too many enterprises and too much complexity in most countries for a general intervention process to have any real hopes of succeeding.

He also warned against general prescriptions of intervention based on the ownership classification of industries. It was certainly true that, in Turkey and elsewhere, inefficiency and losses in public enterprises were a major part of the economic problem and certainly the largest single element in the overall public deficit. However, it should also be borne in mind that private sector industries are often very good at masquerading as efficient, when the reality is that their profitability is frequently dependent on large-scale subsidy and a symbiotic relationship with bureaucracy. The critical element in effective adjustment is not the ownership of resources but the generation of a more competitive environment in which the highest rewards accrue to soundly managed companies—whether public or private—which can re-allocate and manage resources in ways which will be more sustainable in the longer term. While greater competition is the best way to ensure that the necessary adjustments or production occur in a timely manner and with minimum pain, there are no watertight guarantees that this will in fact be the case. In particular, there is a major question as to whether existing companies can survive when asked to forgo long-lived protection and encouraged to undertake major changes in their established forms of production. The prospect that in some cases many will be unable to do so is another reason why external organizations such as the World Bank need to recognize the ultimate responsibility of the local decisionmakers in a country in determining how far and how fast adjustment should proceed.

On the question of the present *international environment,* he noted that widespread debt problems and major external shocks were not a creation of the 1970s and 1980s. Indeed, Europe had suffered four major debt crises in the last 200 years of its economic history and yet had emerged from all of these to become one of the strongest elements in the world economic system. Clearly, countries can survive extremely difficult economic circumstances but still emerge to do well. Equally, the widespread fear of export competition, which leads so many countries into protectionist policies, is largely based on the fallacy of composition. As German critics of protectionism in the 1880s had pointed out and as subsequent experience has amply proven, trade expansion can feed upon itself allowing all participants to reap the benefits from the greatly expanded size of the total cake.

On the question of the adequacy of the external funding to support adjustment he agreed that the dangers of underfunding were serious in cases, such as that of Morocco, where as much as 4 percent of GDP had to be transferred out in the form of interest payments even after some rescheduling of debt. It was important that the Bank and other international agencies worked to ensure that funding was adequate. In the context of the specific countries represented at the seminar however, this was a difficult matter since they were unable to evoke a "continental theme" which could enable them to capture an enlarged share of international capital transfers. They were unlikely as a collective group to evoke the same concern about the provision of basic human needs which was able to attract large funding of programs in Sub-Saharan Africa. Equally, they did not pose the same threat to the stability of the world financial system as was posed by the major debtor countries in Latin America. They would have to work hard therefore to realize the gross transfers of resources which their adjustment efforts of the next few years were likely to require.

He reminded the seminar participants that the Bank itself would be a potential loser from the underfunding of adjustment programs. Indeed, the full funding of programs is the best assurance the Bank has that those programs will succeed and it will be able to recover its own investment. But the reality is that even with the best will in the world, the Bank cannot come close to covering the total borrowing requirement of the EMENA countries. In part this is because of the large magnitude of the estimated gross requirement for the next few years. The Bank's major constraint in this respect is the equity blanket which it has to retain in order to sustain its own borrowing capacity.

While the Bank should continue to leverage as much as possible, the real and prospective threats to its own profitability necessitate that it now has to do this with somewhat more caution than in the past. Its efforts on behalf of the EMENA countries would include an extension of present arrangements to give comfort and support to other lending agencies, whether based on legally based collaboration, or less formal links.

Finally, he reiterated that the seminar has provided him with a great deal of food for thought regarding the adjustment process and the design of programs. It had been a unique opportunity for him to sit down with senior policymakers from the EMENA countries for a discussion of issues of mutual concern. Discussions of such frank and extended nature could never have occurred at the Annual Meetings or in the course of the other business dealings with the Bank. There were several points such as the issues of social costs and the transition costs of adjustment which he would take back to Washington for fuller consideration. He looked forward to future meetings with those represented at the seminar and to the opportunity to reflect at least some of the things learned during the two days in the design of future Bank programs.

Background Papers

Policies of Economic Adjustment to Correct External Imbalances

Jose da Silva Lopes

Introduction

Even though there are important differences among the countries represented in the present seminar—Algeria, Egypt, Jordan, Morocco, Pakistan, Turkey, and Tunisia—it can be said that practically all of them face problems of broadly the same nature, but with different degrees of intensity. They have to combine the correction of their external payments imbalances with efforts to achieve satisfactory rates of economic growth.

All of the countries in the group except Turkey enjoyed a period of very rapid economic expansion in the second half of the 1970s. During that period, Algeria, Egypt, and Tunisia benefited from highly favorable terms of trade resulting from the boom in oil prices. The economies of Jordan and Egypt, and to a lesser extent also those of the other countries, were stimulated by high and increasing remittances from emigrant workers. Important contributions came also from large amounts of official assistance received by Jordan, Egypt, and Morocco and from increased access to external borrowing from commercial sources, particularly in the cases of Turkey and Morocco. The countries of the group were reasonably free for several years from serious balance of payments constraints. Their governments had ample possibilities of stimulating the growth of output through the expansion of domestic demand, both as regards consumption and investment.

The situation changed however quite drastically since the late 1970s. Severe economic difficulties were already affecting Turkey and Morocco in 1977-80, in consequence not only of the expansionary policies of domestic demand adopted in the preceding years but also because of sharp deteriorations in their terms of trade and much lower possibilities of access to international financing. The decline in oil prices, particularly since 1985, imposed large economic losses on the economies of Algeria, Egypt, and Tunisia. Morocco, Jordan, and Tunisia were also affected by substantial reductions in the amounts of emigrants' remittances and of official grants received from Arab oil-exporting countries.

These developments resulted in balance of payments difficulties for all the countries of the group. In several of them, domestic demand continued for some time to expand rapidly. Subsequently, however, the external payments constraints were reflected in considerable reductions in the rates of economic growth.

It is not likely that the favorable world economic conditions, which benefited the countries of the group during the late 1970s and the early 1980s, will reappear again to the same extent in the near future. The outlook for oil prices over the next several years is not particularly encouraging. At the same time, the possibilities of access to international financing will certainly be quite limited in most of the countries mentioned.

In the recent past, practically all the six participating countries have made efforts oriented to the objective of correcting their external deficits. In the years ahead they will continue to face the challenge of combining that objective with the achievement of better rates of economic growth.

The choice of the policies required to meet that challenge depends to a large extent on the availability of external financial resources. When such resources are very scarce, there is no alternative but to correct those deficits very quickly, even if the economic and social costs of adjustment are very high.

The present paper analyzes, in general terms, the policies which are more commonly required to correct the deficits in external accounts and, at the same time, to improve the conditions for future economic growth.

It presents the major differences between the programs of stabilization, which are needed when the balance of payments deficit has to be reduced within a short period, and the programs of medium-term economic adjustment, which involve a more gradual approach. It is argued that, although there are sharp differences between the two types of programs, they rely to a large extent on the same basic policies. However, medium-term adjustment programs are usually far more complex as regards the objectives to be achieved and the instruments to be used. They tend to include measures of structural transformations of productive sectors, drastic changes of economic policies, and reforms of economic institutions, which it would be difficult to envisage in the context of short-term programs of stabilization. The major policies on which both types of programs are based have been analyzed—policies of control, of domestic demand, policies of expenditure-switching, and adjustments in prices of key importance to the economy.

Programs of Stabilization and Programs of Structural Adjustment

The programs of short-term stabilization, typified by the IMF stand-by arrangements, are oriented primarily to the reduction of external payments deficits within comparatively short periods (one or two years). They are designed to produce quick improvements not only in the external current account, but also, to the extent possible, on the balance of autonomous capital movements. The reduction of domestic inflation is also usually one of their main objectives.

The programs of medium-term economic adjustment are exemplified mainly by the World Bank structural adjustment programs, but they include also the programs under the Extended Fund Facilities of the IMF. Medium-term economic adjustment may also be based on a succession of several stand-by arrangements. The programs of medium-term adjustment aim simultaneously at restoring a viable situation in the balance of payments, at ensuring adequate rates of economic development, and at achieving structural changes to prevent the resurgence of payments difficulties in the future. However, they take time to produce their effects: usually not less than three to five years and often more. They require therefore much larger amounts of external resources to finance the balance of payments deficits which persist during the longer periods of adjustment.

The programs of short-term stabilization rely essentially on two types of policies: policies designed to cut domestic demand or to control its expansion (expenditure-reducing policies) and policies which contribute to the strengthening of the competitiveness of the domestic production of tradable goods (exportables or importables) and to shifting the domestic demand from tradable to non-tradable goods (expenditure-switching policies). These programs are usually based on a small number of instruments of macroeconomic policy: ceilings to the expansion of domestic credit and to public sector borrowing, interest rate increase, exchange rate depreciation, and sometimes wage controls and adjustment of some key prices. The governments of countries with serious difficulties in external payments introduce very often a special kind of expenditure-switching by intensifying the restrictions against imports and occasionally by increasing export subsidies.

The programs of economic adjustment over the medium term tend to be more ambitious and cover a much wider variety of policies. They are more oriented to improving the conditions of supply, in contrast with the stabilization programs which rely more heavily on demand management. They are addressed primarily to the correction of distortions in economic policies, to improvements in the mobilization and in the allocation of domestic resources, to the elimination of bottlenecks and rigidities in the productive sectors, and to institutional transformations which may contribute to reinforce the growth potential and to reduce the vulnerability to external shocks.

In spite of the differences mentioned in the preceding paragraphs, the distinctions between stabilization and structural adjustment programs should not be overemphasized. Those two types of programs are often complementary to each other and not completely separate alternatives.

The correction of serious macroeconomic imbalances by means of stabilization programs will often be an indispensable basis on which to lay the foundation of medium-term programs of structural adjustment. The prospects for economic growth in the medium- and long-term tend to be severely impaired by the persistence of high inflation and will be decisively affected if the balance of payments is unsustainable or imposes stop-and-go cycles of expansion and contraction of economic activity.

Moreover, some of the most important policy instruments for correcting external payments imbalances are used simultaneously in stabilization programs and in programs of structural adjustment. Thus, for instance, the effects of adjustment on exchange rates and on interest rates will not be felt only on the demand side. Those adjustment programs may also have an impact on supply if they are maintained for a sufficiently long period. On the other hand, programs of medium-term economic adjustment cannot be efficient if they are not supported by appropriate policies of demand management, which are generally considered as more characteristic of stabilization programs.

In such conditions, the solution found in most countries with balance of payments deficits is to combine policies of short-term stabilization with policies of economic adjustment over the medium term. The relative weights attributed to both types of policies in the mix adopted by a given country depend mainly on the possibility of using accumulated foreign exchange reserves and on the availability of external resources to finance the balance of payments deficits during the period of adjustment. If there are good possibilities of access to comparatively large amounts of resources, the adjustment period can be longer. However, if the foreign exchange reserves are very low, and if the capacity for borrowing and for getting other kinds of financial support from abroad is limited, it will be indispensable to adopt policies of demand restriction and other measures designed to reduce the deficit very rapidly, even if it is clear that the rate of economic growth will be temporarily slowed down and that the social costs involved will be high.

While the access to external resources determines the characteristics of the adjustment programs to be implemented, the design of such programs and the efficiency with which they are implemented will in turn contribute strongly to determine the possibilities of financing the projected external deficits. A good adjustment program, implemented with effectiveness over a sustained period, will enable countries to gain easy access to financial support from foreign commercial banks and international capital markets; from official bilateral sources and from international financial institutions. That influence is particularly evident in the conditionality required by the IMF and the World Bank in their lending operations for balance of payments purposes. Such conditionality is not justified only because they provide the lending institutions with appropriate assurances that they will be reimbursed in due course. A much more important contribution of conditionality is to help the borrowing countries to establish and implement adequate plans of adjustment. The experience of many developing countries which had easy access to loans from international commercial banks during the late 1970s has shown very clearly the dangers of borrowing without adequate conditionality. Those possibilities were often used primarily to avoid or postpone the necessary measures of stabilization and of structural adjustment. The results are well known. Most of the countries that borrowed without conditionality are now saddled with heavy external debts and have very little room for maneuvers in order to achieve satisfactory rates of economic growth in the next several years.

Another important point which must be stressed is that the resort to external financing and the characteristics of the associated programs of adjustment depend on the causes of the balance of payments deficits. The difficulties in external accounts are sometimes created essentially by inadequate macroeconomic policies which lead to the excessive expansion of domestic demand and to distortions in the level of exchange rates, interest rates, or other key prices affecting the entire economy. Such difficulties can usually be corrected without long delays. The solution in such cases

is to adopt short-term stabilization programs supported by limited amounts of external loans to be reimbursed over the medium term.

The balance of payments difficulties which have affected most of the developing countries in recent years have however been of a quite different nature. In most cases, they have resulted originally from external shocks produced by the deterioration of the terms of trade, declining demand or protectionism in export markets, and increase in international interest rates on foreign debt. The concept of external shocks may also include losses in agricultural crops due to bad climatic conditions.

If the balance of payments difficulties are due to external shocks which are considered transitory (for instance a bad harvest or a decline in export prices which is likely to be reversed), the appropriate solution is to finance it. There is no strong need for drastic adjustment measures, unless the unfavorable conditions created by the external shocks persist for a longer period than was originally anticipated.

Very often however, the effects of the shocks are likely to remain for several years, as happened in the case of oil-importing countries with the oil price increases of 1973 and 1979, and in the case of oil-exporting countries with the oil price declines since 1985. In such cases, it will be impossible to avoid medium-term adjustment efforts. Those efforts will also be necessary when the difficulties are to a large extent due to badly conceived policies of economic development, which have contributed to the accumulation of serious structural distortions and inefficiencies over the years.

Demand Management Policies

Restrictive demand management policies are always an essential component of short-term programs for the reduction of external deficits. Those programs rely also on policies aimed at stimulating exports and at reducing the import content of aggregate demand, but the effects of those policies in developing economies are often delayed. By contrast, programs of expenditure-cutting can produce significant results on imports within very short periods. This is the reason why countries in urgent need of correcting their external imbalances have very few possibilities of avoiding restrictive demand policies.

A recent illustrative example is provided by the experience of Algeria since 1985. In order to reduce rapidly the negative effects of the fall of international oil prices on the balance of payments and on the government budget, the authorities introduced substantial cuts in domestic demand by increasing taxes, reducing public expenditure, increasing administered prices, and tightening the credit policy. Together with severe administrative restrictions on imports, those demand management measures limited the current account deficit to 3.5 percent of GDP in 1986 and brought it to near equilibrium in 1987. The economic and social costs of that external adjustment involved were, however, quite heavy. They were reflected in a reduction of the rate of growth of GDP to 1 percent, both in 1986 and in 1987, and in a decline in per capita income.

Demand management policies are needed not only in stabilization programs but also in medium-term programs of structural adjustment. Since the excess of domestic demand over gross national income plus unilateral transfers (including emigrants' remittances) is equal to the current account deficit of the balance of payments, that deficit has to be contained, in the medium run, within strict limits determined by the availability of external finance. It will therefore be impossible to let domestic demand grow for several years at an average annual rate significantly above that of gross national income plus unilateral transfers.

The implementation of demand management policies can however be very different in short-term stabilization programs and in programs of adjustment which are extended over several years. The first important difference is that in short-term stabilization programs, the controls over domestic

demand tend to be more restrictive. In medium-term programs, if the size of the current account deficit which can be sustained during the initial years of the adjustment period is not too low, there will be some scope for expanding domestic demand. There will be time to wait for the expected positive impact of expenditure-switching measures on the growth of output and on the improvement of external accounts, which will create more room for the expansion of domestic demand.

Another important difference is that in programs of medium-term adjustment there are wider possibilities of selecting the expenditures to be reduced. In short-term programs, the restrictions on domestic demand are produced mainly by the tightening of monetary policy and by reduction in the budgetary deficits. The effects of these policies tend to fall more heavily on investment than on consumption. Investment cuts are easier to achieve from the political and social point of view, and as a rule, they will have a quicker and stronger impact on the balance of payments. When the severity of the external disequilibrium imposes restrictions in public and private consumption, it will, in general, be difficult to avoid cuts in social expenditures and increases in the prices of essential goods and services, especially those which were previously subsidized.

In medium-term programs, supported by a higher availability of external resources, there are more possibilities of introducing selectivity regarding the expenditures to be restricted. With a view to ensuring that selectivity, some of the key measures of medium-term adjustment programs must be addressed to the objectives of supporting the growth of investment against that of consumption, of improving the efficiency of investment, and of avoiding adverse effects on income distribution.

The objective of supporting the growth of investment against that of consumption involves the stimulation of national savings. The stimulation of the savings of the public sector requires increases in taxation or reduction in current budgetary expenditure. In many countries, where the ratio of tax revenues to gross national income is already comparatively high, the priority should be to ensure a better distribution of the tax burden than to increase it further. It should be added that an increase in public saving resulting from higher taxes will be partially offset by decreases in private savings. It is for such reasons that in general the main contributions to the increase in public savings should come from a stricter discipline of current budgetary expenditures, involving in particular, cuts in public consumption and reductions in subsidies and current transfers. The reduction of losses of public enterprises is also often an essential component of the policy of increasing the savings of the public sector. Most of the countries involved in adjustment programs have experienced particularly acute difficulties in increasing public savings and reducing budgetary deficits. Despite the efforts made in recent years, the size of the budget deficit continues to be a major problem in practically all the countries participating in the present seminar. In Morocco and Egypt the rate of gross domestic savings have been very low in recent years (around 11 to 14 percent of GDP in both countries), mainly because the savings of the public sector have been negative and have not improved significantly.

Private savings depend on numerous factors and it is not easy to influence them. Important contributions to the stimulation of those savings can result from financial sector reforms, involving increase in the level of interest rates (not if they are repressed at very low levels), a more diversified supply of financial instruments, and improvements in the mechanisms and institutions of financial intermediation.

The measures for improving the efficiency of investment should be aimed both at public and at private investment. When investment has to be cut in the context of programs of balance of payments adjustment, it will of course be essential to concentrate the cuts in the less efficient projects, except those which are near completion. Investments with short gestation periods in directly productive activities, which tend to be undertaken mainly by the private sector, should be the less affected by restrictive policies. This rule should not however be applied too rigidly. Top priority may have to be attached to some specific infrastructural investments by the public sector, designed to remove bottlenecks to directly productive activities.

The increase in the efficiency of public investments, including most of the large investments of public enterprises, will depend mainly on the improvement in the mechanism of development planning. The improvement of the efficiency of private investment is determined mainly by the market signals transmitted to investors. That efficiency will increase if the distortions in relative prices are corrected, if the exchange rate is not overvalued, if interest rates are not repressed at unduly low levels, if there is enough competition, if the protection against imports is not excessive, if the bias against exports is reduced, if investment incentives do not create too large a discrimination among alternative investments, etc.

Finally, the policies of demand management in medium-term adjustment programs should also seek to influence the patterns of public and private consumption. Since it is difficult to change the composition of public consumption abruptly, as a rule it is not enough to rely on annual budgets, unless they are oriented towards medium-term objectives. The definition of such objectives in the framework of structural adjustment programs may bring an essential contribution to the gradual reduction of budgetary deficits and to the improvement of the efficiency of the systems of taxation and public expenditure.

The policies of medium-term adjustment can also result in changes in the patterns of private consumption. They often involve changes in indirect taxes as a substitute for other instruments aimed at restricting some types of private consumption (especially restrictions against less essential imports). The reduction of price subsidies is often envisaged not only in order to reduce budgetary expenditures but also with the aim of stimulating productive efficiency. The replacement of those subsidies by income transfers to the poor and other forms of social assistance will, in principle, contribute much more to social equity than price subsidies, which encourage wastage, distort consumption patterns, stimulate inflation, and often bring more benefits to middle- and upper-income households than to the truly needy.

Policies of Expenditure-Switching

Expenditure-switching policies have played traditionally an important role in programs of short-term adjustment. By stimulating the production of exportable and importable goods and changing the demand patterns in favor of goods which do not enter into international trade, those policies contribute to reducing the severity of the demand restrictions which would otherwise be needed in order to achieve a given balance of payments target. However, in most developing countries the short-term possibilities of achieving important increases in exports or a substantial substitution of imports are somewhat limited. Often, the productive sectors of these countries are not flexible enough to allow for rapid transfers of output and of demand between the domestic market and the international markets. In the medium run, the possibilities of such transfers will however tend to be far more important. For this reason, the contribution of expenditure-switching policies can be particularly effective in programs of medium-term adjustment.

The depreciation of the exchange rate is considered to be the key instrument of such policies. There is however widespread resistance in many developing countries against its use. The governments of those countries have often preferred other measures, including in particular, the introduction of restrictions against imports and export subsidies. Both the economic analysis and the actual experiences of adjustment programs show nevertheless that, in the medium and long run, exchange rate adjustments tend to be far more efficient than import restrictions or export subsidies. International comparisons show that the countries with more success in their efforts towards adjustment to external shocks were those which opened their economies by depreciating the real exchange rate, by reducing the protection against imports, and by eliminating the most glaring distortions created by import restrictions and export subsidies.

One of the most eloquent examples of an adjustment effort with success in reducing the external imbalances and at the same time in stimulating rapid economic growth is that of Turkey since 1980. During the late 1970s the real exchange rate of the Turkish lira was clearly overvalued and the foreign trade and payments regime was based on a complicated system of restrictions and controls. In 1977-79 a serious crisis emerged in the balance of payments. The intensification of import restrictions did not solve that crisis and created serious disruptions in the economy. In 1980, the Turkish authorities changed their economic policies radically, by introducing a program of economic adjustment which involved, among other measures, the progressive depreciation of the real exchange rate, the gradual reduction of import restrictions, and the adoption of an active policy of export promotion. The results of the new exchange rate policy and of the trade liberalization were spectacular. The volume of exports, which had declined by about 40 percent from 1977 to 1980, almost quadrupled in the period 1980-87. The proportion of the imports of goods and services in GDP (at constant prices) rose from 15 percent in 1980 to 22 percent in 1987. In spite of that, the deficit of the balance of payments on current account fell significantly from 5.5 percent of GDP in 1980 to around 2 percent of GDP in recent years. The stimulus of increased exports to aggregate demand and the higher availability of imports contributed to an accelerated expansion of GDP, at an average annual growth rate of 5.5 percent in the period 1980-87.

In order to evaluate the efficiency of the policy of exchange rate depreciation, it will be useful to discuss the following points:

- the time period within which the effects of the exchange rate adjustments will be produced;
- the possibilities of introducing measures designed to reduce some of the undesirable effects of exchange rate adjustments;
- the alternative courses of action which are usually taken when the depreciation of the exchange rate is not acceptable.

As regards the period within which the effects of the exchange rate adjustments will be produced, it is known that such effects will take time (usually more than one year) to become apparent, even in industrialized countries. In developing countries, the supply of export and import competing industries can be stimulated in the short run up to the limits of the existing capacity, but there will be fewer possibilities than in industrialized countries for increasing exports by shifting the sales of a significant proportion of the national output of tradable goods from the domestic market to international markets. The reason for such a situation is that the industries producing for the domestic and for the export markets are more clearly separated from each other than in industrialized countries. Similarly, the stimulus given by the depreciation of the exchange rate to import substitution tends to be weakened by the absence of a sufficient availability of local substitutes for imported products.

In those conditions, the short-run balance of payments effects of the devaluation of exchange rates in developing countries are felt primarily on the demand side. Since the prices of imports increase more than the prices of non-traded goods produced domestically, there will be a transfer of demand from the former to the latter.

The policy of exchange rate depreciation will however become more effective when it is sustained over the medium term and when there is sufficient time to wait for its effects. The better profitability offered to the production of tradable goods will attract investment and other resources into their production. The exchange rate may thus be more an instrument for improving the allocation of resources in the medium term than for producing short-term adjustment in the external accounts.

It is for this reason that the conduct of an adequate exchange rate policy must be one of the essential components of programs for structural adjustment. That policy must however be sustained over a sufficiently long period. One of the limitations of short-term stabilization programs is that the exchange rate measures established in them lose their effectiveness after some time. After a

devaluation, if the domestic inflation exceeds the world average, the exchange rate will become overvalued again in real terms, unless it is corrected at short intervals (by means of a policy of mini-devaluations or crawling peg). The uncertainties and the losses of profitability resulting from the instability of the real level of the exchange rate have been a strong obstacle in many countries against the attraction of new investments into the production of goods which can be exported or which can substitute imports. For these reasons, a program of medium-term economic adjustment, in order to produce the expected results, must include clear guidelines about the exchange rate policies to be pursued over the medium term. Those guidelines should provide assurances, covering a period of several years, that the exchange rate will not become overvalued in real terms, i.e. will be corrected gradually for the differences between domestic inflation and international inflation and will be kept at competitive levels.

The second point mentioned above which must be taken into consideration is that the utilization of the exchange rate policy must be supplemented by other measures. If the depreciation of the exchange rate is quickly reflected in higher prices and wages, its consequences will be mostly inflationary and its effect on the real economy and on the balance of payments will be weak and short-lived. For this reason, it will be indispensable to combine the measures of adjustment of the exchange rate with anti-inflationary demand management policies. The role of these policies is briefly discussed below.

Countries with balance of payments difficulties, which insist on maintaining overvalued exchange rates, are forced to adopt other alternative measures. Their preference is usually to try to save foreign currency by increasing the restrictions against imports and other current payments (import quotas, import licences, higher tariffs, import surcharges, exchange controls on current invisibles, etc.). They may also try to stimulate exports by means of export subsidies.

The main difference between these measures and the depreciation of the exchange rate is that they are selective. They contribute also to the switching of expenditure, but they discriminate among the different types of goods and services which can be imported or exported, while the effects of exchange rate adjustments are linear. There may be some good reasons for discrimination against different types of imports and exports, based particularly on the infant industry argument. However, the experience of numerous countries shows that when those discriminations go beyond moderate levels, their overall effects have frequently been detrimental to economic development in the long run.

Import restrictions and customs duties have been reflected in widely different levels of effective protection of different productive sectors. In many countries it is possible to find at the same time levels of effective protection which are negative for some industries and excessively high for others. In such cases there are serious distortions in the allocation of resources. Agriculture and export industries are among the sectors which are more often affected by negative levels of protection. The impact of import restrictions on the development of exports is particularly important. They will, in general, create a bias against exports, by providing more protection to industries oriented to the domestic market than to export industries.

If exports grow slowly, in the long run it will be impossible to achieve high rates of economic development. Even with tight restrictions, there are minimum limits to the ratio between imports and total demand. The contributions of import restriction and other measures designed to save foreign currency for the reduction of balance of payments difficulties are therefore severely limited beyond a certain point. Without adequate increase in export earnings, the process of economic development will be constrained by the deficits in the external sector, as it has happened in recent years in many developing countries. The creation of conditions for the stimulation of exports should thus be one of the main components of programs of economic adjustment. The policy of correcting the bias against exports, which will be required to achieve that objective, will rely basically on adjustments of the real exchange rate and on import liberalization.

In addition to the example of Turkey mentioned above, the experience of Morocco since 1984, although not yet sufficiently mature, seems to provide also a good illustration about the effects of exchange rate depreciation and trade liberalization on exports. The extremely serious balance of payments difficulties in Morocco in the early 1980s reflected an overvalued exchange rate and a distorted system of incentives to industry. It has been estimated that in 1978 the effective rate of protection was 25 percent for manufactures sold in the domestic market and -17 percent for exports (World Bank: Industrial Incentives and Export Promotion, 1984). Radical modifications in the exchange rate and trade systems were however introduced since 1982. The exchange rate of the dirham depreciated in real terms by more than 25 percent up to 1987. In addition, significant reductions in trade barriers were introduced, including in particular: the increase in the proportion of imports free from quantitative restrictions from 24 percent in 1983 to 88 percent in 1987; the progressive reduction in the maximum import duties from 100 percent in 1984 to 45 percent in 1987. As a consequence of these measures, the exports of manufactures consisting mainly of clothing and other consumer goods, increased 60 percent in dollar terms in the period of two years from 1984 to 1986, and their share in total merchandise exports rose in the same period from 15.5 percent to 22.4 percent.

It should be recognized that as a rule, the elimination of import restrictions will produce their anticipated effects on exports only in the medium term. During the transitional period of adjustment, serious difficulties will in general have to be faced in some industries, which will be more exposed to foreign competition, and in the balance of payments, if some particular imports grow too much. Those difficulties can however be partially avoided if appropriate precautionary measures are taken.

First, the reduction in the level of protection against foreign competition can be compensated at least in part by depreciation of the exchange rate. For example, a 10 percent devaluation of the exchange rate corresponds to a 10 percent tariff on all imports and a 10 percent subsidy to all exports.

Second, the implementation of the program for import liberalization should be gradual. When that implementation takes place over a period of several years, there are less contradictions with the objective of reducing the deficit of the balance of payments because there will be more time to wait for the compensatory positive effects on exports. Moreover, the industries which have been more heavily protected will have more time to adjust to the new conditions by improving their efficiency or by releasing resources (especially labor) which may be transferred to other sectors.

Third, while the programs of trade liberalization require that the levels of protection against imports should be reduced and become more uniform, there may be reasons for maintaining limited discriminations between different goods and productive sectors. There may be, for instance, a valid justification for providing more protection to infant industries, although only within moderate limits and not for excessively long periods.

Fourth, the liberalization of imports should not necessarily imply that the imports of non-essential or luxury goods should become much easier, or that the government should lose the fiscal revenue provided by tariffs or import surcharges on such goods. There will be justification for keeping those tariffs and surcharges when their purpose is essentially to influence the pattern of private final consumption and to provide revenue for the budget. However, when they play at the same time a protectionist role, it will, in principle, be preferable to replacing them by excise taxes or other indirect taxes, levied simultaneously on imports and domestic production. Those taxes will be more efficient from the point of view of the allocation of resources, and at the same time, may have a stronger impact on the pattern of consumption and on the level of revenue.

Fifth, it may be desirable to support the development of exports not only by the exchange rate policy and by the liberalization of imports, but also by granting some incentives specially aimed at exports and by adequate institutional measures. Specific export incentives may be justified on a temporary basis as a means of offsetting the bias against exports which will persist until the level of

protection against imports is reduced to a very low level. They may also be justified by the infant industry argument, which can be extended to industries which, even if they have a long experience in their domestic markets, are just beginning to make the first contacts with export markets. However, even when they are justified, export incentives must be kept within narrow limits: they may become too expensive to the budget; they may create undesirable administrative arrangements; they may create undesirable distortions in resource allocation; and they may bring about negative reactions from other trading partners or from the GATT. These problems may be avoided in part by the appropriate choice of incentives to be granted in favor of exports. A special emphasis must be given, for instance, to the simplification of the administrative formalities affecting exports, to supplying exporters with information about external markets, to technical assistance to exporting firms, to the subsidization of training in the export sector, etc.

Adjustment of Key Prices

Apart from the measures of expenditure reduction and of expenditure-switching analyzed above, the program for the reduction of external payments imbalances involved a large variety of other measures which were sectoral, microeconomic or institutional in nature. Those measures are included primarily in programs of medium-term economic adjustment but they may be found also, although with a different perspective, in programs of short-term stabilization. It would be impossible to analyze in the present paper all the measures of that kind. The following present only some comments about the adjustment of prices which play a key role in the economy: administered prices, wages, and interest rates.

Administrative prices have pervasive effects on the efficiency and on the equilibrium of the economy. Very often they are kept at artificially low levels for social and political reasons or with the purpose of suppressing inflation. Usually they are not promptly adjusted to cost increases and tend to lag behind inflation. They often impose heavy losses on enterprises, particularly when they belong to the public sector, and are sometimes a cause for negative rates of protection in the sectors affected. As a result, they discourage investment and growth of production in those sectors. Important negative consequences tend to be felt mainly in the sectors that produce essential goods and services, including in particular the agricultural sector, the housing sector, and public utilities. The controls on prices at artificially low levels require often large subsidies to consumers or to producers and may become one of the main causes of large budget deficits. In addition, administered prices may be an obstacle to structural economic adjustment. The policies of exchange rate depreciation and of trade liberalization can only be effective if their impact can easily be transmitted to the structure of relative prices.

For all these reasons, practically all the adjustment programs undertaken in recent years have involved substantial changes in price policies.

A recent example is that of Algeria. In the face of difficulties resulting from the fall in oil prices, the authorities raised the prices of several agricultural crops, reduced the subsidies to consumer prices and introduced more flexibility in the prices of products of public enterprises. These changes in the price policies, although only partial, increased the incentives to farmers, strengthened the financial situation of public enterprises, reduced the budgetary expenditure, and improved the allocation of resources.

The implementation of policies of price liberalization must be adapted to particular conditions of each country. If the prices have been controlled for a long time at levels far below those that would prevail under market-determined equilibrium, it may be necessary to adopt a gradual approach in their liberalization. It may, for instance, be preferable to increase controlled prices to levels which reflect more accurately the costs of production, before introducing their full liberalization. In some countries, the abrupt and total elimination of controls has produced the overshooting of prices. As a

consequence, countries which suffered for some time from problems of price instability, and from declines in real demand and output before liberalized prices, found their equilibrium levels, with controls removed.

The complete elimination of price controls will not be easy to achieve in sectors that are dominated by monopolistic or oligopolistic structures or which do not have full competition. When feasible, the best solution for such cases is to introduce more competition. This may be done by programs of trade liberalization which increase the competition from imports. This may be done also by changing internal regulations which affect competition, by implementing measures against the business restrictive practices of private firms in dominant or oligopolistic positions in specific markets, and by stimulating the entry of new competitors into those markets. However, in sectors where a competitive market is not feasible, like in public utilities, it will, as a rule, be indispensable to maintain administered prices. Those prices must reflect the long-run marginal costs and be adjusted to their changes, but it must be recognized that the practical application of this principle is extremely difficult. There are enormous difficulties in getting all the data required for the calculation of such costs and for estimating the productivity trends on which they should be based.

It is sometimes argued that the introduction of price controls for limited periods can be justified when they contribute to lowering inflationary expectations and to restraining the increase in wage levels. The effectiveness of temporary price controls as an anti-inflationary device depends however very closely on the precautions that are taken regarding their utilization and the policies that should supplement them. If they are kept for comparatively long periods (for instance more than 6 to 12 months in countries with moderately high inflation), they will generate significant distortions in relative prices and the original purpose of reducing inflation will be defeated very quickly. Moreover, their effects should be reinforced by the simultaneous use of other anti-inflationary policies, including the restrictions of domestic demand and the wage policy. In particular, the contribution of restrictive demand policies will be of crucial importance. If the budget deficits continue to be high and if the monetary policy is too accommodating, price controls may repress temporarily the signs of inflation, but those signs will reappear again, with increased vigor, after some time.

The controls on wages have been an important instrument of economic stabilization and adjustment in the countries where their adoption has been possible. The ceilings to wage increases can play a dual role: given their influence on private consumption, they may be an important instrument of demand management, and they may contribute to the reduction of the unemployment effects of anti-inflationary policies; on the other hand, they can contribute to the effectiveness of exchange rate adjustments and to the increase of the competitive power of domestic production against foreign goods.

It can be argued that wage controls, combined with the depreciation of the exchange rate, have resulted in substantial declines in real wages in the countries which have adopted these policies. However, in those countries, the alternative solutions would probably lead to more unemployment, to lower average levels of living, and to worse income distribution. Without wage controls, there would be the risk that the effects of the exchange rate depreciation would be dissipated rapidly in higher inflation. As a consequence, the real exchange rate would not be brought down to the level which ensures a satisfactory competitive power for exports and for import competing industries. The demand policies would therefore have to be more restrictive in achieving a given reduction in the current account external deficit. With slower growth of domestic demand and of exports, total output would be lower and unemployment would tend to be higher. Although it is usually argued that wage controls combined with exchange rate depreciation lead to widening income inequalities, the result will tend to be the opposite, if they contribute to reducing the risks of unemployment, of inflation, and of loss of international competitive power.

The interest rate is another key price which plays an important role not only in short-term stabilization, but also in medium-term structural adjustment. The effects of interest rate changes are felt in the growth of domestic demand (particularly as regards stocks and other investments), on the amount of emigrants' remittances, on the inflows or outflows of autonomous capital movements, on the rate of private financial savings, and on the volume and composition of investment.

There has been a lively controversy about the effects of interest rate adjustments on the level of private savings. The effects are probably low in many countries as compared with the effects of other factors (growth of disposable incomes, social security arrangements, patterns of income distribution, organization of capital markets, etc.). There is however reasonably good evidence that the proportion of private savings which are placed in financial instruments tend to respond quite significantly to interest rate changes. This effect will be important because savings which are placed in gold, foreign currency, real estate, or durable consumer goods contribute very little to economic adjustment and to economic growth. The efficiency of investment will be stimulated not only by the higher availability of financial savings, but also by other changes in interest rate policies, including adjustment in excessively low lending rates (which result in credit rationing and encourage capital intensive investment with low social rates of return), reduction of the interest rate disparities which result from distorted selective credit policies, and reduction of tax charges levied on financial transactions.

In many developing countries it will be difficult to introduce the complete liberalization of interest rates within a short period. When they are determined administratively, the levels of interest rates should depend not only on the expected domestic rate of inflation but also on the exchange rate policy and on the interest rates abroad. As a rule, it will not be possible to isolate entirely the domestic financial market from external influences by means of capital controls. In countries which are largely exposed to international trade, there are often capital movements desguised in the current account. Moreover, experience has shown that emigrants' remittances have been quite sensitive to interest rate differentials and to exchange rate policies and that very often they have been channeled to parallel markets.

Conclusion

There has been widespread reluctance in accepting adjustment measures with the characteristics of those which were analyzed in the preceding sections. That reluctance can be explained by several factors.

First, many governments tend to pay more attention to the hardships which they can avoid in the present than to the problems that the delays in their undertaking adjustment efforts may create in the future. They often emphasize the immediate political and social difficulties of adjustment measures but neglect the costs of postponing implementation of those measures, even when there is some awareness that such costs will grow exponentially with time.

Second, governments are often constrained by the pressures of powerful economic and social groups in their choice of the best adjustment policies. They are often forced to attach a higher priority to the interests of those groups than to wider national objectives, like the growth of national output or social equity.

Third, it is not always recognized that the effects of a given type of policy can be very different in the short run and in the medium and long run. Thus, for instance, the contribution of price controls to the reduction of inflation may seem apparently positive in the short run, but in the medium run these controls tend to aggravate the economic disequilibrium and to impair the future growth of output. Conversely, the effect of exchange rate depreciation on improving the current account may seem weak in the short run, but will often be substantial in the medium and long run.

Fourth, it is often forgotten that the effects of a given policy depend to a large extent on the coordination with other policies and from supplementary measures of support, which should be integrated into consistent packages. Thus, for instance, the contradictions between a policy of trade liberalization and the objective of reducing the current account deficit can be avoided to a large extent by appropriate adjustments in the exchange rate and in specific indirect taxes.

The governments which persisted in the refusal or postponement of adjustment policies of the types analyzed in the present paper have not been able in general to find better alternative solutions. But it cannot be said that the success of these types of policies is always automatically guaranteed. The results achieved depend not only on the packages chosen but also to a large extent on the effectiveness of their implementation. The lack of determination and continuity shown by the governments of many countries in their adjustment efforts has been an important cause of failure. In the face of the difficulties which they inevitably create, those efforts have often been abandoned or reversed before the end of the period during which they were to produce the expected results. The result has been a succession of stop-and-go episodes, with low average rates of growth and economic instability.

The validity of the adjustment programs depend also crucially on the diversity and on the consistency of the measures which they include. It should be borne in mind that a large variety of measures will tax the limited administrative capacity of many developing countries. Those measures should nevertheless be sufficiently diversified to achieve simultaneously the designated objectives of economic stabilization, of economic development, and of structural transformations. They should reinforce the positive effects of each other and contribute to reducing the difficulties which would be found if only some of them were implemented.

The preceding comments show that the tasks of adjustment are formidable. There are however ample rewards for the efforts which they require. There is a clear lesson provided by the experiences of countries which have achieved significant success in adjusting their economies to changes in the world economic environment.

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External Debt, Inflation, and the Public Sector

Towards Fiscal Policy for Sustainable Growth

Sweder van Wijnbergen

Introduction

The 1982-1983 recession in the U.S. and the ensuing rise in interest rates and collapse in commodity prices triggered the debt crisis that has dominated macroeconomics in the developing countries ever since. While the almost exclusive focus on Latin America would lead one to believe otherwise, other developing countries have not escaped the problems such adverse shifts in the world environment cause. A strategy to deal with external debt and the formulation of internal policies that allow sustainable growth within the limits of creditworthiness and macroeconomic stability are at the forefront here as they are elsewhere. Those issues are also the subject of this paper.

The stage is set by a brief overview of external debt developments since 1980. We use this overview to highlight what choices need to be made to arrive at an external debt strategy, and the trade-offs involved. At issue is, whether restrictive expenditure policies should be pursued to improve current account performance. To what extent will such policies come at the cost of future output growth, thus undermining the benefits of any debt reduction that does take place? Are there alternatives, that allow satisfactory output growth within the limits set by creditworthiness constraints? What is the role of exchange rate policy in all this? A real depreciation stimulates exports, an essential element of maintaining creditworthiness; on the other hand, real depreciation causes capital losses on external debt, thus raising the burden of any given level of debt in terms of the goods that need to be exported to service the debt.

Sustainability of an external debt strategy, and its social costs and economic benefits, depend to a large extent on the internal policies that form the counterpart of any external adjustment undertaken. External adjustment requires a transfer to be made to foreigners (or adjustment to a lower transfer to be received from them); internal adjustment deals with the way the matching internal surplus of savings over investment is brought about. To this process, and the role the public sector can play in it, the paper turns next. The central question here is, how to bring about the necessary surplus of savings over investment at levels of investment high enough to sustain output growth.

An important part of any program of internal adjustment is the extent to which the public sector contributes directly towards the necessary improvement in the savings surplus. To this end, the fiscal deficit will typically need to be brought down. Any remaining deficit has to be financed, by issue of domestic or foreign debt or by revenue from monetization. But macroeconomic targets for say inflation and output growth, in addition to the constraints on debt issue implied by continued creditworthiness and solvency, impose restrictions on each financing method. Hence the issue of fiscal consistency. Do these targets and constraints allow the government to raise sufficient revenue to cover the deficit on which it has decided as part of its internal adjustment program? The absence of such consistency forebodes future policy change and so undermines the credibility of the fiscal program envisaged. The final part of the paper discusses the interactions between fiscal deficits and macroeconomic variables upon which fiscal consistency hinges. The paper draws on empirical work on Turkey to show the trade-off between fiscal policy adjustment and sustainable inflation. We discuss the impact of financial sector reform, economic growth, and real exchange rate policies on this trade-off; how it is affected by the interest rates on foreign and domestic debt; and when and how postponing adjustment adversely affects the terms at which this trade-off takes place.

A Brief Historical Overview: Debt, Output Growth, and the Real Exchange Rate

Debt-output ratios in the Mediterranean region range from a low 24 percent in Algeria[1] to a high of more than one in Morocco, both in 1986. The average for the region increased from 35 percent in 1980/81 to almost 50 percent in 1985/86. The median value of almost 60 percent in 1986 puts the region well into Latin American territory. This value is higher than the average for the group of 15 "high-debt" countries listed in the IMF's World Economic Outlook (WEO). Thus, by current international standards, external debt is high in the Mediterranean region.

However, it is important to see such measures in perspective. Countries like the U.S. and the U.K. have also run up large debts in corresponding periods in their economic history. Britain financed much of its industrial revolution in the early nineteenth century by borrowing from cash-rich Holland. With that process completed as the century progressed, Britain itself turned into a lender and financed much of the economic expansion in the U.S. and Argentina, at the time a dynamic economic power. The American move towards the West and the extension of Argentina's railroad system were financed by borrowing from abroad. It took to the middle of the current century for the U.S. to reverse the tables and turn itself into the net lender it was until the deficit period of the last few years. In a similar manner, continued investment in the developing countries in the seventies was driven by the accumulation of external debt.

The historical examples show that extensive debt accumulation occurred before; they also demonstrate that the borrower-lender cycles that are a part of this process often stretch themselves out over many decades. It has often taken that long for major borrowers to turn around and engage a role of lender rather than borrower. From this vantage point, the current emphasis on short-term solutions to what has become known as the "debt crisis" may very well be unwarranted.

An essential feature of the two or three successful examples of external debt accumulation mentioned is that the high rate of foreign borrowing fueled substantial capital accumulation and thus output growth. The high output growth and accompanying productivity increases made it possible for the countries involved to eventually engage in actual lending rather than borrowing as time progressed and investment needs declined. It is this element that is maybe the most worrisome aspect of the current debt situation: in almost all debtor countries the rate of output growth has fallen to a postwar low. The fifteen high-debt countries listed in the IMF's World Economic Outlook (WEO) saw their output growth fall from over 5 percent per annum in the seventies to only 1 percent in the 1980s. The Mediterranean region is no exception to this rule: oil importers and oil exporters alike saw their growth rates fall by close to four percentage points, a fall that is even more pronounced if Turkey, the one exception, is excluded. The importance of high output growth is brought out clearly by a closer look at Turkey's performance since its series of debt reschedulings in the late seventies (see Table 1).

In Turkey, the ratio of gross debt to output has increased from 28 percent to 56 percent between the end of 1980 and 1986. On this account, Turkey has moved in line with the average for the 15 "high-debt" countries (see Table 1). In fact it is surprising that the debt-output ratio did not rise more rapidly in Turkey than it did in the "high-debt" countries: as a percentage of GNP, Turkey ran a much lower non-interest current account surplus than the group of "high-debt" countries did on average after their respective debt crises (-0.25 percent of GNP for Turkey over the period 1980-1986 versus 2.6 percent over 1982-1986 for the "high-debt" countries). This apparent inconsistency is explained by the much higher growth rate that Turkey managed to sustain since 1982. Turkey's

1. Calculated using the official exchange rate, which is severely overvalued. A more realistic exchange rate would lead to a much higher ratio.

1982. Turkey's debt-output ratio followed a path similar to that of the "high-debt" countries, not so much because of large surpluses, but because of its high output growth.

This is where Turkey is most strikingly different from the "high-debt" countries. Figure 1 shows Turkey's growth rate since 1980 compared with the growth rate in the countries that the IMF classifies as having debt-servicing difficulties. Turkey's growth rate exceeds the real growth rate in the "high-debt" countries by 4 and 5 percentage points in almost every year since 1980. On the average over these six years, the real growth rate in the Turkish economy has exceeded the average growth rate in the "high-debt" countries by no less than 4 percentage points.

Table 1. Measures of the Overall Debt Burden

	1980	*1981*	*1982*	*1983*	*1984*	*1985*	*1986*
Turkey							
Debt (US$ billion)	16.3	16.9	17.6	18.2	20.8	25.5	32.5
Medium/long-term	13.8	14.7	15.9	16.0	17.6	20.8	25.6
Short-term	2.5	2.2	1.8	2.3	3.2	4.8	6.9
Debt/GNP	28.0	28.6	32.8	35.6	41.5	47.9	55.9
Debt/exports	284.1	198.3	175.0	192.9	180.5	194.5	260.5
Current Account Surplus/GNP	-5.04	-2.83	-1.55	-3.57	-2.81	-1.90	-2.63
Non-Interest Current Account Surplus/GNP	-3.89	-0.81	1.17	-0.36	0.36	1.39	1.04
Countries with Recent Debt-Servicing Problems:							
Debt/GDP	33.6	38.5	45.5	50.0	51.1	52.2	54.8
Debt/exports	151.2	185.8	241.5	254.3	247.2	263.9	302.4
Current Account Surplus/GDP	-3.6	-5.9	-5.5	-2.0	-0.9	-0.5	-1.8
Non-Interest Current Account Account Surplus/GDP	-0.5	-1.7	-0.5	2.8	4.1	4.2	2.5

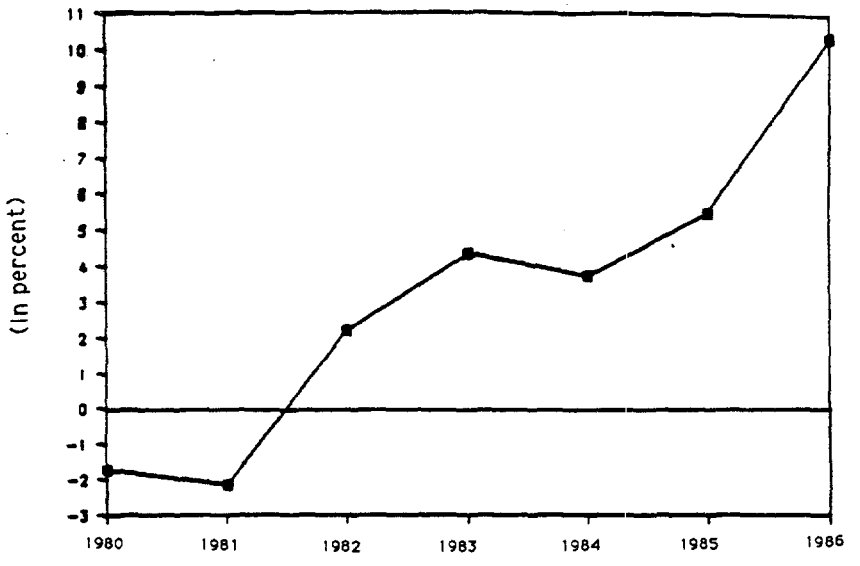
Notes: For comparability the debt figures reported here for Turkey refer to gross debt. In the rest of the chapter net debt is used. See Page 1, footnote 1 in the text.
The debt-export ratio refers to year-end to exports of goods and servicing during the year.
Countries with recent debt-servicing problems are defined as those which incurred external payment arrears in 1985 or rescheduled their debt during the period from end-1963 to end-1986.
Source: Undersecretariat of Treasury and Foreign Trade, Central Bank and World Economic Outlook (IMF).

Higher growth reduces debt-output ratios as time goes by, or at least slows down their rate of increase. Against this process works the impact of interest payments on debt incurred in the past. Higher real interest rates increase debt-output ratios through accelerating debt-service costs. For any given net resource transfer, the debt-output ratio will increase (fall) further if real interest rates exceed (fall short of) the real growth rate of the economy. From this perspective, the world environment has turned distinctly unfavorable. Real interest rates were negative by any measure in the seventies, but have increased rapidly over the past few years. Figure 2 shows the real interest rate on foreign debt for Turkey. The comparison has turned sharply negative. Even for Turkey, which grew at a much faster pace than the rest of the region, real interest rates no longer fall short of the real growth rate in the economy.

Table 1 shows another striking feature where Turkey differs from most "high-debt" countries, including the Mediterranean region. In debtor countries across the world, the ratio of debt to exports rose in line with the debt-output ratio. On this measure, Turkey has been more successful than the

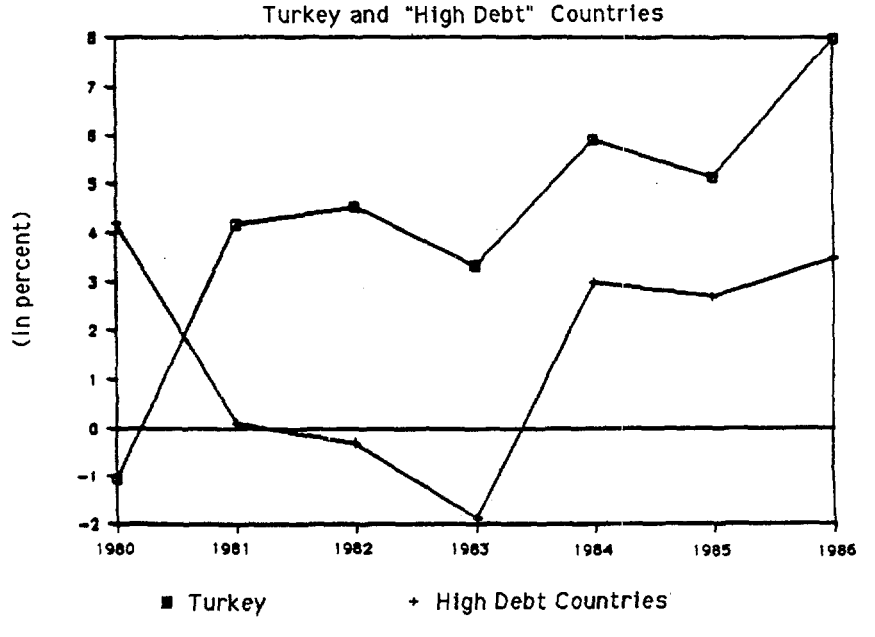
"high-debt" countries. Turkey alone among the debtor countries, saw its debt-export ratio fall by a third after 1980, with not much deterioration afterwards. The ratio of exports (of goods and non-factor-services) to GNP hovered between 5 and 7 percent of GNP between 1967 and 1980. The

Figure 1. Real Interest Rate on Foreign Debt



Note: Real Interest Rate Corrected for Cross-Currency Effect

Figure 2. Real Output Growth



reform measures implemented since have caused a dramatic turn around. Exports jumped to 11 percent of GNP in 1980, up from 7.15 percent in 1979, and have been increasing as a share of GNP ever since. Exports reached 20.7 percent of GNP in 1985, then fell back to 18 percent in 1986 because of developments in the Middle East but have more than recovered in 1987. Exports are estimated to have grown by 30 percent in real terms in 1987. The net effect of this is that while the Turkish debt-output ratio has steadily deteriorated, the ratio of debt to exports, after a substantial improvement between 1980 and 1981, has by and large stayed constant since.

Empirical analysis shows that the real depreciation effected since 1980 was a major contributing factor to the successful export drive. Without any real depreciation, exports would, the analysis suggests, have increased by a few percentage points of GNP only. This fact needs to be taken into account when assessing the impact of the real exchange rate on the debt.

The counterpart of this real depreciation, however, has been a substantial capital loss on Turkey's external debt. This was a major contributing factor to the increase in the debt-output ratio; it accounts for more than half of the increase in the debt-output ratio between 1980 and 1986. Empirical results show, however, that the debt-export ratio will in fact improve after a real devaluation: exports will increase enough in volume terms to offset the negative price effect. Clearly, the debt-export ratio would have been much more unfavorable without the depreciation that actually took place. A real devaluation causes a capital loss on foreign debt and thus a reduction in national wealth. Higher exports cannot undo this, but increased export orientation eases access to foreign capital markets. It is doubtful that Turkey would have had the access to external markets it did enjoy without the successful export performance generated by the reform program. The real depreciation of the exchange rate was an essential component of that program.

Towards the Formulation of an External Debt Strategy

This brief survey suggests that for an analysis of external adjustment, three factors are of major importance. First, the non-interest current account, as the most fundamental measure of the net resource transfers between a borrowing country and the rest of the world. Second, exchange rate developments, both between the borrower and its trading partners (captured by the real exchange rate), and between the country's trading partners and creditors themselves (cross-currency exchange rates). Third, the way real interest rates paid on external debt interact with the growth rate of the economy to set the pace at which the dynamics of debt and output growth unfold over time. These are in fact the three factors to which any increase in the debt-output ratio can be traced. [2]

The first term equals the non-interest current account deficit of the balance of payments. This is the most fundamental measure of a country's external (im)balance: it equals the difference between total expenditure (net of interest payments on foreign debt) and nationally generated income. Its counterpart is the net resource transfer the country receives from foreigners: the increase in debt minus interest payments made. If the non-interest current account is zero, the increase in debt exactly equals interest payments; the debt grows at the rate of interest in this case. As long as there is a surplus on the non-interest current account, foreign borrowing is less than interest payments to

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2. The decomposition is based on accounting identities. Define the debt-output ratio b* as:

   $b^* = (B^*/P^*).e/y$; $e := E.P^*/P$

e is the real exchange rate, B^* is the dollar value of foreign debt, P^* is the dollar-based, export-weighted price index of foreign goods, and *E* the nominal exchange rate of the local currency against the dollar. *P* is the local Turkish price index. Increases in the debt-output ratio can be traced to the following components:

   $b^* = nicasy + (r^* - n)\, b^* + {}^*eb^*$

a "." indicates changes and a "*" percentage changes. nicasy is the ratio of the current account surplus to GNP. r^* is the average real interest rate on foreign debt and *n* the real growth rate of GNP.

foreigners; or, to put it another way, the growth in foreign borrowing is less than the rate of interest. In that case, a net resource transfer to the rest of the world takes place. The opposite will happen when there is a deficit on the non-interest current account: in that case the debt will grow faster than the rate of interest. A debt growing faster than the rate of interest will eventually lead to insolvency.

The second component captures what might be called an autonomous effect inherent in the mechanics of debt, real interest rates and output growth. If the non-interest current account is zero, the numerator of the debt-output ratio grows at the rate of interest; the denominator obviously grows at the (real) growth rate of the economy. Therefore, if the real interest rate exceeds (falls short of) the real growth rate of the economy, the debt-output ratio rises (falls) if the non-interest current account is zero. This term therefore measures the dynamics inherent in the interplay between real interest rates and real output growth. This is referred to as the debt dynamics component in this section. If real interest rates exceed the real growth rate by a substantial margin, the dynamics term will contribute significantly to increases in the debt-output ratio; the room for non-interest current account deficits will be limited accordingly.

The final term measures the capital loss a country incurs on its external debt when the exchange rate depreciates in real terms. The debt-output ratio measures the debt in terms of home goods; if their relative value falls, as it does after a real depreciation, the debt-output ratio necessarily rises. Against that must set the favorable impact of the real devaluation on exports, an important determinant of creditworthiness.

We now turn to a discussion of the role these three factors play in different external debt strategies. In the current world environment, an external debt strategy consists of two choices. The first choice is between two alternative ways of restraining the ratio of external debt to GNP:

(a) effect a net resource transfer to creditors through sufficiently large surpluses on the non-interest current account;

(b) pursue a high output growth policy; high growth slows down the extent to which external debt feeds on itself through escalating debt service costs in an unstable manner.

Option (a) is the one pursued by most Latin American and Eastern European debtor countries since 1981/82. The problem with this approach is vividly demonstrated by their experience. The only reliable and practically implementable way of bringing about a surplus on the non-interest current account is through substantial cuts in expenditure. This may, however, cause substantial loss of output. One reason is the potential short-run recessionary impact of expenditure cutbacks. A more fundamental cause of output losses arises because the expenditure cutbacks are likely to come out of investment, thus slowing down output growth. But this opens up the possibility that gains made through improvements in the non-interest current account are offset by a widening excess of real interest rates over real output growth rates. Effectively, what is gained on the numerator is at least partially lost again because of a slow down in the rate of increase in the denominator of the debt-output ratio. This is what happened in most of the "high-debt" countries. While Turkey did make substantial external adjustment, it did not take this route and thus avoided the destabilizing spiral in which most other "high-debt" countries seem to be trapped.

Option (b) relies on a policy geared towards high output growth, to slow down the dynamic process of debt feeding on itself through escalating debt service costs as a share of GNP. The main problem with a low-trade-surplus/high-growth strategy is that the Government needs to make sure that the extra expenditure the lower trade surplus allows is indeed channeled into productive, trade-oriented capital accumulation. Even if this is done, either through increased public sector investment or through incentives for private investment or both, the strategy could fail because of a potential clash with the export drive that, we will argue, should also be part of a successful external debt strategy. Higher investment expenditure will invariably increase aggregate demand for home goods and put upward pressure on the real exchange rate. The growth strategy would then crowd out

exports and jeopardize creditworthiness by diverting production away from traded goods. The only way out is an active attempt to create room for exports by restraining public and private consumption. This would also alleviate any pressure on imports and the trade balance that could result if no such consumption restraint would accompany the increased investment expenditure. All these issues really concern internal adjustment problems, to which we turn in another section.

The discussion of the pros and cons of each option also demonstrates that they are, in practice, mutually exclusive. Running high surpluses on non-interest current account will typically lead to slower growth, as investment falls. As a consequence, the debt-dynamics terms increase as the growth rate falls below the real interest rate on external debt. Conversely, higher growth and the investment expenditure it requires is almost certainly going to require continued net resource transfers from abroad.

The second choice concerns the role of the real exchange rate. A real depreciation raises the debt-output ratio but lowers the ratio of debt to exports. Should a country opt for real depreciation and export orientation and simply accept the associated losses on external debt? Is there an alternative, involving less exchange rate depreciation?

A real appreciation lowers the ratio of external debt to output by lowering the relative price of foreign goods (in which the foreign debt is expressed), in terms of home goods (of which GNP is made up, by definition). However, a steady real appreciation implies a steady increase in the relative price of home goods, which would, in the absence of policy changes, induce an increasing excess supply of them. The only way this can be avoided is to raise the one component of demand for home goods that is likely to be both least price-sensitive and under control of policymakers.

Government expenditure: Such a strategy would see Government expenditure rise and exports fall as time goes by. In addition, domestic consumers would increasingly shift from more expensive home goods to foreign goods. As a consequence, such a strategy is likely to lead to a deteriorating trade balance, which would eventually force its abandonment. The anticipation of such events is what is behind the exchange rate crises that have characterized many Latin countries over the past few years. Turkey has in fact followed the opposite strategy: its concerted export drive has been based on a commitment to an exchange rate strategy designed to maintain or steadily improve Turkey's external competitiveness. This requires real depreciation of the exchange rate. Empirical evidence widely supports the view that such a strategy is essential to maintain creditworthiness. Commercial credit ratings invariably put a great deal of emphasis on the degree of export orientation in the economy. The conclusion seems clear: there is little alternative to an exchange rate based export orientation as an essential component of an external debt strategy, the associated capital losses on external debt notwithstanding.

Solvency, Creditworthiness and Foreign Debt: What is a Sustainable Current Account Deficit?

Assume that the borrowing country has considered the evidence and decided that the Latin American or the Eastern Europe example is not particularly attractive. It thus decides to take option (b): pursue a high-growth strategy within the limits set by solvency and creditworthiness constraints. The formulation of such a strategy would start with a decision on what exactly constitutes a sustainable current account deficit; this strategy calls for borrowing up to that limit, and internal adjustment policies that make sure that the additional borrowing is translated into investment and output growth. In this section we discuss one approach to sustainable borrowing. The next section covers the matching internal adjustment programs.

Assessing a country's room for external borrowing involves two considerations: solvency and creditworthiness. Solvency concerns ability to pay and is intricately linked to the non-interest current account, real interest and output growth rates, and, finally the initial level of debt. To remain

solvent, a country should not plan expenditures higher than its current and future income (discounted) minus its initial debt. This implies that the non-interest current account surplus should at least equal the initial debt times the difference between the real interest cost of foreign debt and the real output growth rate.[3]

A number of important consequences follow from this. First, a country with a higher income, or a country with a lower debt, can borrow more than a country with a higher debt-output ratio. Second, the more expensive a country's external debt, the higher its surplus on the non-interest current account should be if it is to maintain solvency. Third, the higher a country's growth rate, the more leeway it has in borrowing without jeopardizing solvency. The latter conclusion reflects the vicious circle so many debtor countries face: slow growth implies less room for external borrowing, which in turn causes slower growth and so on.

For most countries, solvency constraints are not very restrictive. Turkey's ratio of net foreign debt to GNP equals 51 percent. Even if the average real interest rate on its external debt remains as high as 8 percent, solvency would only require a surplus on the non-interest current account of one percent of GNP for a real output growth rate of 6 percent. On the plausible assumption of an average real interest on foreign debt of 6 percent, this would imply a lower limit of zero on the non-interest current account. A continued deficit on the non-interest current account would eventually jeopardize solvency at current levels of interest rates and projected output growth rates.

However, solvency is not the only consideration. Ability to pay does not necessarily imply willingness to repay. Creditworthiness (which depends on lenders' assessment of a country's ability and willingness to repay) therefore often imposes tighter constraints than solvency alone. Repayment requires not only a sufficiently high value of wealth to be able to repay, but also the generation of a surplus of traded goods production over trade goods consumption (net exports). This is likely to be much burdensome in a country with most of its resources in non-traded goods sectors than in an outward-oriented country. But if it is more burdensome, a country might be more tempted not to repay, even if solvency requirements are met. Hence the importance of debt-export ratios in the assessment of creditworthiness.

Assessing the precise limits imposed by creditworthiness constraints is difficult for several reasons. First of all, while debt-export ratios are important, they are a biased estimate of the ratio of a country's debt to its output of tradable goods. Some domestically produced tradables are likely to be sold at home rather than exported. So the true measure lies somewhere between the debt-output ratio (which also counts non-tradables) and the debt-export ratio, which excludes tradable goods produced and sold at home. In a recent study completed for Turkey we followed an approach pioneered by Cohen (1985, 1987). This approach chooses the ratio in between the debt-output (D/Y) and the debt-export (D/X) ratios in such a way that there are no incentives to overvalue or undervalue the exchange rate simply to mechanically improve creditworthiness indicators. The precise way in which this ratio is derived is presented in the Cohen export demand and output

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3. The current discounted value of income less expenditure equals (Y-C-I)/(r*-n) if real interest rates and growth rates are constant. Y is national income before foreign interest payments; C and I aggregate consumption and investment expenditure; r* the rate of the economy. Y-C-I equals the non-interest current account surplus. If this expression should not fall short of the initial debt, the following must hold:

(1) (Y-C-I)/(r*-n) > B*, or

(2) (NICA)> (r*-n)B*

Expressing NICA and B* as shares of GNP and indicating them by lower case letters gives the expression discussed in the text:

(3) nica > (r*-n)b*

Strictly speaking, this formula is only valid if output growth rates are likely to remain roughly constant.

supply. The outcome for Turkey places a 60 percent weight on debt-export ratio and a 40 percent weight on the ratio of debt to GNP. This construct is referred to as the debt-resource ratio, D/R.

A second, more fundamental problem, involves not so much the choice of any particular creditworthiness indicator, but how to assess whether the value of the indicator chosen is too high or not (high values indicate low creditworthiness). An indicator is too high (creditworthiness too low) if at that value the burden of servicing the debt exceeds the likely penalty on non-compliance to repayment terms. The problem with this definition is that nobody really knows how high that penalty is. We have followed Cohen in a very simple but forceful approach to this issue. The cost of default is not known, but if a country has not defaulted at the current value of its debt-resource ratio, that value is, by implication, not yet too high. Otherwise, the country would have defaulted already. A cautious borrowing policy then is a policy that will prevent a rising debt-resource ratio.

One important caveat: it does not follow from this analysis that a borrowing policy designed to rapidly lower debt-resource ratios is necessarily a good idea. While it is true that lower debt-resource ratios indicate higher creditworthiness, the transitional costs of reaching that lower ratio clearly raise the cost of servicing the existing debt. Since creditworthiness involves comparing the cost of default with the cost of servicing the current debt, such a strategy, which has been imposed on many high-debt countries, would lower rather than increase current creditworthiness.

How much foreign borrowing is compatible with maintaining the debt-resource ratio at its current value, and hence maintaining the level of creditworthiness? Since the debt-resource ratio is weighted average of the debt-output and the debt-export ratio, it will depend on the growth rate of the borrowing country and of its trading partners. The growth rate of its trading partners is one of the determinants of a country's likely export growth. The other determinant is the elasticity of demand for the borrowing country's exports with respect to income in the countries to which it exports. Consider the following example for Turkey.

Empirical analysis suggests that the income elasticity of demand for Turkey's exports is high: 1.6 with respect to the OECD and 4 with respect to the oil-exporting countries in the Gulf region (Anand et al., 1988). This results in a weighted value of 2. Thus, if the weighted output in Turkey's trading partners[4] grows by 4 percent, Turkey's exports are likely to grow by 8 percent.

The results are presented in Table 2. The table gives the maximum increase in foreign debt that will avoid a rising debt-resource ratio, for different growth rates at home and abroad. The table lists the increases in debt and hence gives the feasible current account deficit. The table lists on its vertical axis various alternative growth rates for Turkey, ranging from 3 to 7 percent. On the horizontal, top axis it lists potential growth rates for Turkey's t rading partners, aggregated, using their respective

Table 2. Sustainable Current Account Deficits (percent of GNP) and Output Growth at Home and Abroad

Output Growth of Turkey	*Output Growth Rate of Turkey's Trading Partners*					
	0	1	2	3	3.5	4
3	1.12	1.21	1.29	1.38	1.42	1.46
4	1.49	1.58	1.66	1.75	1.79	1.83
5	1.87	1.95	2.04	2.12	2.17	2.21
6	2.24	2.33	2.41	2.50	2.54	2.58
7	2.61	2.70	2.78	2.87	2.91	2.95

Source: Anand et al., (1988)

4. Weighted by their share in Turkey's exports.

shares in Turkey's exports. The numbers indicate, as expected, that lower growth rates, whether at home or abroad, allow for less debt accumulation. In fact for zero growth rate at home and abroad, the formula indicates that no further borrowing is possible (this possibility is outside the range of the table). Raising the domestic output growth rate by 4 percentage points allows an extra current account deficit of 1.5 percent of GNP for given foreign output growth rate. A slump abroad lowers borrowing potential: if growth in trading partner countries falls from, say 4 percent to zero, the amount of feasible debt accumulation goes down by 0.3 percentage points of GNP.

Internal Adjustment: Towards a Consistent Fiscal Policy

Once the feasible current account deficit has been decided upon, a matching internal adjustment program needs to be set up. An internal adjustment program consists of a set of policies that will bring about a fiscal deficit and a private savings surplus over investment just enough to match the external current account target. The challenge is to design this package in such a way that total investment, private and public, will be high enough to allow output to grow at its target rate. This involves once again a two stage design. First how much should the public sector contribute to the required improvement in the surplus of aggregate savings over investment? The issue here simply is, how much should the fiscal deficit be cut back. Once this has become clear, the difference between the targets for fiscal deficits and external balance needs to be made up by the private net savings surplus. The policy instruments that have the most influence on this are interest rates and tax policy. How they should be used in this context is the subject of the next section. In this section we discuss the first question, how large should the deficit be.

In the long run, the size of government needs to be determined on the basis of views on the role of the public sector in the economy, and the distortionary costs of raising the revenue necessary to finance the associated expenditure. Such considerations are however of little help for the medium-run focus that is appropriate for the issues discussed here. Instead we suggest a more modest approach.

This approach starts from the assumption that the government has certain target values for such variables as inflation, output growth, and so on. In addition, there are the constraints imposed by sustainability of the current account deficit, as we saw in the previous section. Similar considerations play in the analysis of domestic debt issue. Such considerations imply restrictions on the feasible public sector deficit as we will argue below. Consistency with other macroeconomic targets provides policymakers with an answer to the question, how large should the deficit be? Optimality of fiscal deficits is a more complicated target, satisfaction of which needs entirely unavailable data. Consistency with other stated macroeconomic targets, however, is much easier to assess, and is anyhow a sensible requirement. Absence of consistency is a clear signal that one policy or another will need to be changed in the future; the government surely does not want its hand forced by private speculators acting on such signals.

Consistency of Fiscal Policy

Consistency analysis starts from the mundane observation that there are three sources of financing public sector expenditure beyond what can be obtained from the regular tax system: external borrowing, monetization, and issue of domestic interest-bearing debt. The amount that can be expected from each source will depend on other macroeconomic targets, such as inflation, output growth, interest rates and so on. The revenue from these three sources of financing can be combined into the calculation of a "financeable deficit." This is defined as the deficit that does not

require more financing than is compatible with sustainable external borrowing, existing targets for inflation and output growth, and a sustainable internal debt policy.[5]

Underlying the framework suggested here to calculate the financeable deficit is a model describing private portfolio choice as a function of inflation, output, and interest rates (see van Wijnbergen et al., 1988). This gives the amount of currency, demand deposits, and time deposits the private sector is willing to hold given output, inflation, and the level and structure of interest rates. This is coupled with a simple financial sector model incorporating reserve requirements and other bank regulatory policies to derive the demand for reserves by commercial banks. The demand for reserves is then added to the demand for currency already derived to get an estimate of the total demand for base money given inflation, interest rates, and so on. All this is used to derive total revenue from monetization for different output growth rates, interest and inflation rates, and regulatory policies.

To the revenue from monetization must be added the revenue that the government can expect from external and internal debt issue given its external borrowing policies and debt management approach. The results of such an exercise for Turkey are summarized in Tables 3 and 4. Underlying these Tables are various targets and assumptions: a real growth of 6 percent a year is the most important one. We furthermore assumed the late 1987 values for reserve requirements and nominal interest rates on demand and time deposits. As to liquidity requirements, only the part over which no interest is paid is incorporated; the remainder is included in the definition of interest-bearing public sector debt held by the banking system. The public sector can expect slightly in excess of 3 percent of GNP from issue of internal and external debt if sustainability and creditworthiness constraints are to be met.

Table 3 first assesses potential revenues from seigniorage[6] and the inflation tax[7] for various inflation rates. Listed are demand for currency, demand deposits, and time deposits as a function of interest rates and so on for various inflation rates. It then calculates revenue from inflation tax and seigniorage, and adds the two to arrive at total revenue from monetization.

The table shows that both components of base money are very sensitive to inflation.[8] As inflation rises from 15 percent to say 60 percent, demand for currency falls from 3 percent of GNP down to 2.5 percent. The combined total of demand and time deposits falls from a predicted 25 percent of GNP at 15 percent inflation down to 18 percent at an inflation rate of 60 percent. Not surprisingly, total demand for base money, listed in the column BM, also falls: from 6.8 percent of GNP at 15 percent inflation down to 5.2 percent at 60 percent inflation. It is clear from the next column that higher inflation leads to higher revenue from inflation tax: it goes up from 1 percent of GNP at 15 percent inflation to 2.5 percent at an inflation rate of 60 percent. Total revenue from monetization also rises but at a slightly lower rate, because the other component, seigniorage, actually declines as inflation rises. This is negligible effect, however.

Table 4 adds up the revenue the government can expect from external borrowing subject to the constraints outlined elsewhere in this paper, from monetization for different inflation targets, and from the issue of interest-bearing domestic debt. The total is called the financeable deficit: a deficit

5. A simple version of this framework was first used in Anand and van Wijnbergen (1987). The current version incorporates external debt considerations and implications of the financial structure for inflation tax revenues. It is presented in detail in van Wijnbergen and Anand (1988).

6. It is the net revenue devised by any money-issuing body (e.g. a note-issuing authority).

7. If the government finances its purchases by means of an increase in the money supply and the aggregate supply curve in the economy is inelastic, prices will rise so that all holders of money balances will find their real purchasing power diminished in a manner analogous to an increase in, for example, income tax.

8. Measuring asset-stock-to-GNP ratios and revenue from the inflation tax involves corrections for differences between beginning-of-period and average price levels.

of that size is sustainable and will not compromise any of the macroeconomic targets mentioned. One additional assumption needs to be mentioned. In the calculations underlying the Table, it is assumed that issue of interest-bearing domestic debt is kept down to a rate that will maintain the ratio of domestic debt to total GNP. The reason for not allowing a faster rate of domestic debt issue is the high interest rate it currently carries; at 12 percent a year, it is well above the real growth rate of the economy. At this rate, debt-service will escalate as a percentage of GNP if more extensive use is made of debt-issue to finance the deficit; we will explore this at greater length in the next section.

Table 3. Inflation Tax and Seigniorage at Various Inflation Rates *(Percent of GNP)*

Inflation Rate	*Currency*	*Demand Deposits*	*Time Deposits*	*Base Money*	*Inflation Tax Revenue*	*Revenue from Monetization*
15	3.0	7.5	17.5	6.8	1.0	1.4
20	2.9	7.3	16.7	6.6	1.2	1.6
25	2.9	7.1	16.0	6.4	1.4	1.8
30	2.8	6.9	15.3	6.2	1.6	2.0
35	2.7	6.7	14.7	6.0	1.8	2.2
40	2.7	6.5	14.1	5.8	2.0	2.3
45	2.6	6.3	13.5	5.7	2.1	2.5
50	2.6	6.1	13.0	5.5	2.2	2.6
55	2.5	6.0	12.5	5.4	2.4	2.7
60	2.5	5.8	12.1	5.2	2.5	2.8

Table 4. Financeable Deficit at Various Inflation Targets *(Percent of GNP)*

Inflation Rate	*Financeable Deficit*	*Actual Deficit in 1986*	*Required Deficit Reduction*
15	4.4	5.7	1.3
20	4.6	5.7	1.1
25	4.8	5.7	0.9
30	5.0	5.7	0.7
35	5.2	5.7	0.5
40	5.3	5.7	0.4
45	5.5	5.7	0.2
50	5.6	5.7	0.1
55	5.7	5.7	0.0
60	5.8	5.7	-0.1

The Table shows the financeable deficit as a function of the inflation rate. A target of 50 percent, close to the 1987 inflation rate on a year-end-to-year-end basis, allows a deficit of 6 percent of GNP; an inflation target of 20 percent would allow only 4.9 percent of GNP. If the financeable deficit is subtracted from the actual deficit, one obtains the cut in the deficit necessary to achieve macroeconomic consistency (the column labeled RDR, for Required Deficit Reduction). The actual deficit is the deficit actually registered over 1986, net of capital losses on external debt.[9]

9. Capital losses on external public sector debt are exluded, not because they would not constitute a real increase in public sector liabilities, but because they are unlikely to recur in the future. This is certainly the

The actual deficit in 1986 is compatible with a sustained inflation rate of almost 50 percent: the RDR turns negative when inflation goes from 55 percent to 60 percent. The Table also shows that a target rate for inflation of 20 percent implies a required deficit reduction (RDR) of 1 percent of GNP. However, the Tables are drawn up under the assumption of constant nominal interest rates. In particular, the time deposit rate is kept fixed at 55 percent. This would imply a real rate of interest of 29 percent, clearly an unsustainable situation. Real rates on bonds would have to rise to similar levels for the Treasury to be able to issue them, with predictable consequences for debt-service cost. An alternative scenario would lower the nominal rate of interest in line with inflation in order to maintain real rates of interest. This will lead to lower demand for time deposits by comparison. But empirical analysis suggests that some of this shift (almost a third) will go into demand deposits. This moderates the impact of lower time deposits on base money demand and hence on the basis for the inflation tax. The net effect is a decrease in the financeable deficit at 20 percent inflation, and hence an increase in the required deficit reduction, from 1 percent to 1.2 percent of GNP.

Several comments are in order. First, 1.2 percentage points of GNP is in fact a large adjustment. It would, for example, require a 9.4 percent cut in public sector investment, or a 13.7 percent cut in public sector consumption. Second, a larger cut will be needed if instead of zero real depreciation, the real exchange rate should be expected to depreciate at a positive rate over the five years under consideration. This is taken up further below. Third, preliminary estimates suggest that the fiscal deficit has widened substantially in 1987. The required deficit reduction would be commensurately larger.

Fiscal Implications of Financial Sector Policies

The previous section demonstrated the importance of revenue from monetization in the financing of government expenditure. In such circumstances, changes in financial regulation may have important fiscal consequences. Changes in reserve requirements, shifts out of domestic assets, changes in the interest rate structure on deposits etc., all influence the level of reserve money the private sector and the commercial banks will hold for any given inflation rate. Fiscal consequences should therefore be taken into account when recommending reforms affecting any of these variables.

Consider for example changes in reserve requirements. These were recently increased from 10 percent to 14 percent on all domestic currency deposits. This clearly raised the level of required reserves for any given deposit, interest rate structure and inflation rate. Hence base money demand went up and revenue from monetization increased. Empirical analysis suggests that the amount of increase in base money supply is likely to have yielded a once-off gain of 1 percentage point of GNP in extra revenue; in addition, since the level of base money demand will stay higher as long as these reserve requirements are kept at 14 percent instead of 10 percent, there are recurrent gains in both inflation tax and seigniorage. This is because the tax is now levied over a higher base. As a consequence, the increased reserve requirements eased to fiscal adjustment burden by 0.25 percent of GNP in each year the reserve requirements are kept at 14 percent. This lowered the sustainable inflation rate by more than 10 percentage points to the 50 percent level where it is now.

In many countries, reserve requirements are different against deposits of different maturity. Turkey's value of 14 percent is not unusual as a reserve requirement ratio against demand deposits.

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case with the cross-currency-fluctuations component; while nobody can accurately predict major exchange rate movements, there is a consensus that the dollar has "bottomed out." The assumption of no real depreciation for given cross-currency rates may be more contentious; we explore the consequences of alternative scenarios below.

But, at least in many other OECD countries, reserve requirements against time deposits are much lower. We can use the same framework to assess the fiscal implication of lowering the reserve ratio applicable to time deposits to, say, 5 percent. This would have a substantial impact on demand for base money, since reserves held against time deposits are a major component of it. The equilibrium level of base money demand would drop by no less than 1.5 percent of GNP in response to such a regulatory change. This would present a once-off revenue loss of that magnitude for the public sector. In addition, future revenue from inflation tax and seigniorage would be reduced, since the level of base money demand would be lower for any given inflation rate. The loss would be substantial: at an inflation rate of 40 percent, the combined loss in inflation tax and seigniorage because of this cut in reserve requirements would be 0.4 percent of GNP each year. Any such reform measure should therefore be accompanied by fiscal measures to offset what is quite a substantial negative budgetary impact.[10]

Increases in demand deposit rates have similar consequences. An increase in the demand deposit rate to 50 percent (which would make it positive even at 1987's high December-to-December inflation rate[11]) triggers substantial shift out of cash balances: almost 1.3 percentage points of GNP. Since reserve requirements on demand deposits are only 14 percent, this lowers demand for base money by 86 percent of the shift. The econometric analysis also suggests that there would be an additional shift out of non-financial assets into demand deposits, of about equal size, but this would raise demand for base money by not more than 14 percent of the shift. The net impact on the level of base money demand and hence on revenue from monetization would thus be negative. By coincidence the magnitude of the required fiscal adjustment is almost identical to what is required after a cut in reserve requirements back down to 10 percent.

One should exercise care in interpreting such results. Pointing out the negative fiscal consequences of, say, cuts in reserve requirements does not imply that no such cuts should be undertaken. High reserve requirements carry efficiency costs that have not been incorporated in this analysis. It does mean, however, that reform packages incorporating measures like this should also specify to what extent and in which manner the fiscal consequences should be dealt with.

Fiscal Implications of Debt Management

What would have happened if Turkey had not followed its policy of a relaxed external deficit and only moderate internal debt issue? In particular, what are the fiscal consequences of a debt substitution policy followed in many debtor countries? Many of them in effect paid off relatively cheap external debt from revenue raised by issuing much more domestic debt.

Assume that Turkey had not increased its external debt at all between 1980 and 1986, other than what was caused by capital losses due to exchange rate depreciation, but instead had issued internal debt. The study on Turkey referred to before showed that after correction for cross-currency exchange rate fluctuations and real depreciation of the TL, Turkey's debt-output ratio went up by only 13.8 percentage points of GNP. The rest was due to capital losses. What would have happened if Turkey, instead of increasing its external debt-output ratio by 13.8 percent of GNP, had issued an equivalent amount of internal debt instead?

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10. An additional consideration should be the impact of differential reserve requirements on monetary control. With uniform reserve requirement, shifts between different deposits do not influence the demand for base money. However, any portfolio shift between demand and time deposits will influence base money demand if there is a significant difference between reserve requirement ratios applicable to the two types of deposits. This would complicate monetary policy considerably.

11. The December-to-December inflation rate is probably a misleading indicator of the underlying "core inflation rate" for 1987. Extensive public sector price level adjustments caused a shift in the price *level* of 12 percent in December 1987 alone.

First the results of a mechanical debt swap: a once-off sale of domestic debt to retire an equivalent amount of external debt. This effectively amounts to a debt-buy-back scheme. This experiment considers only the budgetary consequences of changing one type of debt instrument for another. It does not consider the transfer problem associated with effecting any transfer of resources to foreigners.

Such a scheme becomes problematic when domestic real interest rates are substantially higher than the average real interest cost of foreign debt. This would also be an issue in Turkey: over the 1988-1992 period, real rates at home are projected to be 6 percentage points above the average real cost of foreign debt. As a consequence, the increased interest burden caused by such a debt swap would raise the actual fiscal deficit by 0.8 percent of GNP in each subsequent year, and the required deficit reduction for consistency with 20 percent inflation rises to 2.1 percent of GNP, up from 1.2 percent of GNP in the base case. Alternatively, the equilibrium inflation rate would jump to 85 percent per year, up from 50 percent, if no fiscal adjustment would be undertaken.

A straight asset swap was, however, not the form in which this debt substitution was implemented in most high-debt countries. In order to effect the implied transfer to foreigners, the government needs to find a way to increase either its own surplus or the net private savings surplus by a matching amount. Typically, the domestic counterpart of the increased external transfer was a gradual increase in domestic debt issue, absorbed through an increase in the private net savings surplus. This in turn required higher real interest rates. Such a strategy would be much worse from a budgetary point of view. The reason is that this scheme would in fact raise the cost of the internal debt beyond its already high level and thus worsen the impact on the budget further. Assume that such a debt substitution strategy would be implemented over the next five years. Since over that period real interest cost of foreign debt is assumed to equal the real output growth rate, the entire adjustment would need to come out of the non-interest current account. To achieve the target reduction of 13.8 percentage points of GNP over a five-year period thus requires a substantial positive shift (2.7 percent of GNP, 13.8 divided by 5) in the non-interest current account in each year.

Inducing an increase in net private savings requires a rise in the real interest rate. The empirical analysis discussed elsewhere (Anand et al, 1988) suggests that such a large increase requires an increase in domestic real interest rates of almost 7 percentage points. This would not only raise the servicing costs of the additional domestic debt created during such a policy, but also the cost of debt incurred earlier as it gets refinanced. This is important because by now most of Turkey's internal debt has a short maturity (by December 1986, 76 percent of the internal debt had a maturity of one year or less). The impact on the budget would be large. To sustain consistency with a 20 percent inflation target after such a debt substitution policy would now require a reduction in the fiscal deficit of 3.6 percent of GNP. This is almost double the adjustment necessary after a straight asset swap. The budget deterioration would in fact be so large, that covering it through monetization would no longer be feasible. Increased debt issue would be even worse because of the high real interest rates. Finally, external debt would not be available by the very design of the scheme, which was to reduce external debt. A fiscal cutback would thus be unavoidable and would have to be substantial. This raises the issue of whether output growth could in fact be sustained. This is explored further in another section, but the numbers presented here should already indicate that it is highly unlikely.

Fiscal Consequences of Exchange Rate Policy

Another issue concerns exchange rate policy. Turkey has followed an aggressive export promotion policy, in which the exchange rate has been one of the major instruments. Turkey's export-weighted real exchange rate has depreciated by an average 6 percent in real terms since 1980. This has been the most important factor behind Turkey's extremely successful export drive. Its counterpart, however, has been increasing capital losses on its foreign debt. Nevertheless, in spite of increases in its debt-output ratio, export growth was so high that the debt-export ratio has remained fairly stable since 1981.

The trade-off then is clear. Continued depreciation of the real exchange rate will help to maintain export growth in excess of the growth rate of real GNP, but at the cost of an escalating debt burden as measured by the debt-output ratio. Empirical analysis reported in Anand et al. (1988) shows that the net impact on the debt-export ratio is, however, positive. The trade-off then will depend on which target is adopted for external borrowing. If the solvency-oriented debt-output ratio is the constraint on external borrowing, higher real depreciation will severely restrict the room for fiscal deficits. With the debt-to-export ratio as the constraint on external borrowing, however, this result will be reversed as a consequence of the high price elasticity of Turkish exports.

Table 5 demonstrates these effects numerically using the consistency model just described. The table presents the fiscal cutbacks required for consistency with a 20 percent inflation rate for different rates of real depreciation. It does so for two different scenarios. In the first scenario (columns 2 and 3 in Table 5.3), external borrowing is restricted to just the amount that would leave the debt-output ratio unaffected (this is a positive amount, since output is growing). The table clearly shows how, under such an external debt policy, capital losses on foreign debt due to real depreciation of the exchange rate severely restrict fiscal policy. A required fiscal deficit cut of 1.2 percent of GNP at zero real exchange rate[12] depreciation jumps to 3.0 percent at a five percent real depreciation. If the real exchange rate depreciates by 10 percent on average over the five-year period, the required deficit reduction (RDR) increases to no less than 4.9 percent of GNP. The main reason for this is reduced room for external financing: this fall from 2.6 percent at zero depreciation to 0.8 percent at a real depreciation of 5 percent (the columns under FCA, feasible current account deficit, in the table). At a real depreciation of 10 percent there is no room for external borrowing at all.

Table 5. Real Exchange Rate Depreciation, Fiscal Adjustment, and Feasible External Borrowing

Real Exchange Rate Depreciation	*Debt-Output Target CA*	*Debt-Export Target RDR*	*FCA*	*RDR*
0.0	2.6	1.2	2.5	1.3
5.0	0.8	3.0	3.6	0.2
10.0	0.0	4.9	4.7	-0.9

FCA = Feasible Current Account Deficit
RDR = Required Deficit Reduction

The results are very different if the target is to maintain a constant debt-to-exports ratio. In that case, real depreciation eases room for external borrowing since the volume effect on exports offsets the valuation effect on debt. Feasible external financing under this scenario goes up from 2.5 percent at zero real depreciation to a very high 3.6 percent at 5 and 4.7 percent of GNP at 10 percent real depreciation. The extra fiscal room this gives is reflected in the corresponding RDR row.

Both options are obviously too extreme. A strict debt-output target would be too restrictive a guidance for external borrowing. Pursuing an exchange rate-based export promotion policy while ignoring the favorable impact this has on creditworthiness would unduly restrict external borrowing. The real depreciation necessary for the export promotion strategy would cause capital losses on external debt. Maintaining the debt-output ratio would then require a reduction in foreign borrowing. It might, in fact, by the fiscal restraint it would necessitate, threaten the export boom that the real depreciation was intended to produce. This could happen if the fiscal restraint would

12. This is the deficit reduction required (with respect to the 1986 fiscal deficity) for consistency with a 20 percent inflation target.

directly, or indirectly, lead to reduced investment in export sectors. The other policy, targeting the debt-export ratio, would clearly also carry high risks. If the export boom falters, the economy would be left with a high debt-output ratio and the possibility of a sudden cutoff from external funds.

In Conclusion

The analysis has until now focused on the revenue the government can expect from various sources of financing given its macroeconomic targets. Reducing the fiscal deficit to what is financeable given those macroeconomic targets makes sure that the fiscal policy is at least sustainable. If this adjustment is made, achieving the stated macroeconomic targets will not be jeopardized by fiscal crises, high inflation, or escalating interest payments. However, it does not guarantee that those macroeconomic targets can or will be achieved; only that the fiscal deficit is not inconsistent with them. Whether the targets can be achieved depends on two major factors. First, will the private sector in fact generate a sufficiently large surplus of private savings over private investment for the economy to achieve its external targets, given the fiscal deficit? Second, this surplus should be achieved at sufficiently high levels of investment to meet output growth targets given the public investment program. The extent to which public sector policy can play a role in this process is the subject of the next section.

Internal Adjustment: Public Sector Policy and Private Savings and Investment Behavior

The analysis assumes that the borrower has opted for a growth-oriented strategy within the constraints that sustainability of foreign borrowing imposes, rather than to rely on high surpluses on the non-interest current account to keep the debt-output ratio in check. The key factor determining the success or failure of such a strategy is an internal adjustment program that relies sufficiently on reduced consumption rather than reduced investment to generate the internal surplus that is required. If consumption does not fall, either external targets or output growth will need to be sacrificed; the former if investment is not reduced and the latter if it is.

The central question thus is whether external restraint and consistency requirements for fiscal deficits leave enough room for public and private investment and satisfactory output growth. Can external balance and output growth be reconciled, or is there an inherent conflict between these two objectives?

It is here that the interaction between private sector savings and investment decisions and fiscal policy becomes important. The way consistency between internal policies and external targets can both be met without jeopardizing output growth: does the private sector run a surplus at high levels of savings and investment or at low levels? If the surplus is achieved by increasing savings for sustained investment levels, output growth can be maintained. If however the adjustment comes mostly out of investment cutbacks for given private savings rates, external adjustment is bought at the cost of lower output growth.

This section focuses on the role that fiscal policy and real interest rates can play in bringing about these developments. There are several channels through which fiscal policy influences the size of the private sector's net savings surplus, and the level of investment at which any given surplus is achieved. First, fiscal policy may exert a direct influence on the net private savings surplus through real interest rate-based crowding-out. The overall fiscal deficit is important for this channel.

But if high real interest rates are maintained to create the room for higher fiscal deficits without a matching current account deterioration, how can output growth be maintained? High real interest

rates presumably slow down at least private investment, thus slowing down output growth. Fiscal policy can play a role in avoiding such a slowdown in two different ways. The first one focuses on policy instruments that to some extent will focus the effect of high real interest rates towards consumption restraint while shielding private investment. Investment incentives, tax measures, and credit policy all play a role here. Second, output growth depends on aggregate investment, not just on private investment. There is therefore a role for public investment in reconciling external balance and output growth. Government investment itself results in capital accumulation. So negative output effects of fiscal deficits through real interest-based crowding-out of private investment can be offset to some extent by shifting the composition of government expenditure away from consumption to investment. The composition of government expenditure, and not just the overall deficit, is an important part of a successful internal adjustment program.

In addition to this direct substitution effect there is a more indirect channel through which the composition of government expenditure influences private investment. Public sector investment, especially in infrastructure, often stimulates rather than replaces private investment expenditure. Public sector investment in, say, roads will make investment more attractive for the private sector in places that were inaccessible before. This channel is one reason why private sector investment in Turkey has in fact not suffered that much from the continued high real interest rates over the past five years.

The Role of Public Sector Investment: The Case of Turkey

Large fiscal deficits have until now not prevented a satisfactory current account performance. The price for this has been the need to maintain increasingly high real rates of interest. Empirical analysis shows that in Turkey such a policy is effective by restraining private consumption, and, to a lesser extent, private investment expenditure. Deleterious effects on output growth have until now been avoided. High public sector investment has been an important explanation of why output growth did not slowdown.

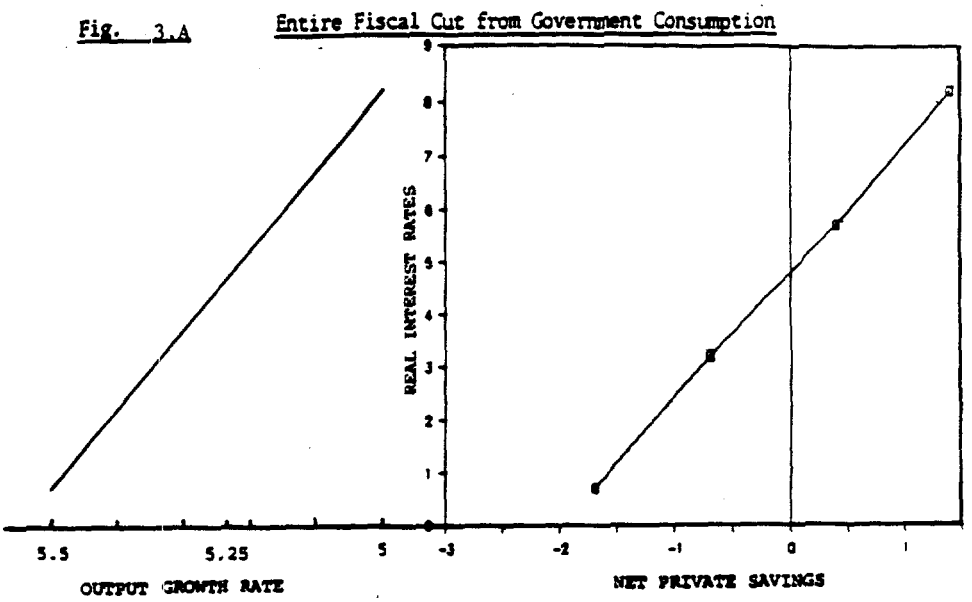
Figure 3 shows the results of simulation runs made with an econometric model used in Anand et al. (1988). The runs are designed to bring out the role of public sector investment in the growth process. Interest rates were varied, but fiscal deficits were adjusted so as to maintain external balance targets. First, the fiscal cutbacks necessary to sustain external balance as interest rates are lowered were assumed to come entirely from government consumption. Public sector investment remains constant by assumption. The figure shows that a 5 percentage point cut in interest rates will cause a drop in the private sector's surplus of savings over investment of 2.1 percentage points of GNP (see Figure 3, upper right).[13] A substantial part of the decline in net private savings comes from increased investment by the private sector in response to the lower real interest rates. Since public sector investment was fixed by assumption, output growth goes up, by 0.5 percentage point of GNP on average over the five-year period the model was run (see Figure 3A, upper left; the base run simulates the period between 1981 and 1986).

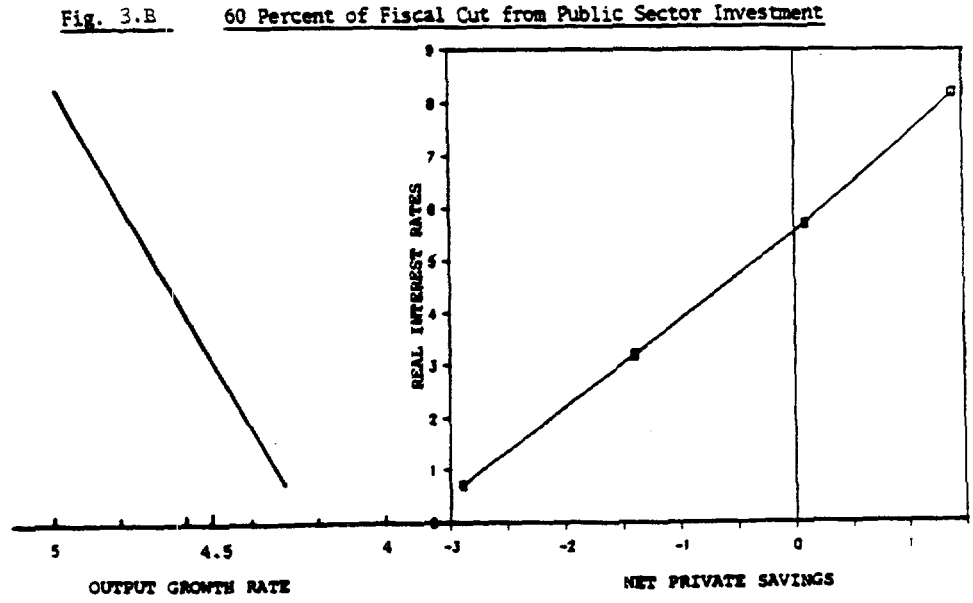
The results are very different when the fiscal cutbacks are assumed, perhaps more realistically, to come also from public sector investment rather than from consumption. Assuming that all government expenditure would be cut back proportionally implies that 60 percent of the cut comes from reductions in the public sector's investment program. The results are summarized in Figure 3B. Now while the lower interest rates stimulate private investment, the cut in public sector investment more than offsets this: as a result, output growth actually declines by an average 0.5 percentage point of GNP over the five -year simulation period. Shifting from no cut in public sector

13. In the run, the spread between lending rates and deposit rates was kept constant. A 5 percentage points cut in borrowing rates thus implies a 5 percentage points cut in lending rates too.

investment to letting 60 percent of the fiscal adjustment come out of cutbacks in public investment therefore cause a full percentage point drop in GNP growth for the five years over which the model was run.

Figure 3. The Effect of Changes in Fiscal Deficit on Interest Rates and Output Growth





There is a vicious circle aspect to this policy experiment. Cutting public sector investment reduces output growth, which in turn will lead to a smaller private sector's savings surplus. As a consequence, fiscal deficits and hence public sector investment need to be cut further to maintain external balance, and growth slows down more. A 5 percentage points cutback in real interest rates requires a cut in the fiscal deficit of 2.1 percentage points of GNP if external balance is to be maintained through reduced government consumption. However, with 60 percent of the cuts from public investment, deficits need to be reduced by 2.8 percentage points, a full 0.7 percentage point of GNP more.

The arguments presented here do not imply a blanket endorsement of ever increasing public sector investment; public sector investment of course does come at a cost.They do highlight, however, that public sector investment has played an important role in Turkey's strong growth performance over the last few years. Moreover, they show that stabilization programs relying on reductions in public sector investment could have high and permanent negative output effects through the mechanisms demonstrated. These are in addition to any output effects that may arise because of short-run macroeconomic problems, which are not covered here.

Summing Up

This paper has provided a guided tour around the building blocks of an external debt strategy and the policy implications that the necessity of a matching internal adjustment program lead to. By way of summing up, we would like to comment on two issues: the role of real interest rates and the actual implementation of the measures discussed.

High real interest rates in a growth-oriented adjustment program sound like a prima facie contradiction in terms. High growth requires high investment, and high real rates clearly slow investment down. However, high real rates may be necessary to make sure that a sufficiently large private savings surplus is generated to make fiscal deficits and external balance targets consistent. As we discussed before, investment incentives and tax measures could be used to make sure that most of the effect of the high real rates is shifted towards reducing consumption rather than investment.

It is clearly true that a larger public sector deficit cutback generates less need for high real rates. This would obviously be desirable; artificially high interest rates, at least to the extent that they exceed world interest rates, are a price distortion just like any other wedge between domestic and world prices. However, cutting fiscal deficits implies welfare costs too. While there is often room for reducing government consumption expenditure, there is a stage where further cuts cause excessive damage to the quality of government services. Similarly, public investment programs often include inefficient projects. But we have demonstrated that public investment also has an important role to play in achieving sustainable growth. Excessive cuts will jeopardise that policy goal. Finally, higher taxation too carries its costs. Higher taxes are almost always possible, and often desirable. However, higher taxes invariably imply higher price distortions and increased tax evasion. This way of reducing deficits has its limits too. The conclusion is that lower fiscal deficits for given interest rates and higher interest rates for given deficits are both adjustment mechanisms that cause welfare costs one way or another. A properly designed adjustment program should therefore include some of each, so as to minimize the overall welfare costs of the adjustment program as a whole.

A final comment, to put the approach taken in this paper in perspective. The crisp sequential way in which the whole process was discussed is to some extent a simplification, useful for presentational purposes, but is also an underestimate of the difficulties likely to be encountered in practice. One example should suffice to demonstrate this. We argued that, once consistency calculations have indicated the sustainable size of the fiscal deficit, high real rates may be needed to

guarantee a matching surplus of private savings over investment. Furthermore, additional investment incentives may be needed to guarantee that this surplus is brought about at a sufficiently high level of private investment. But both these policies will in turn have a negative impact on the budget and hence change the need for deficit reduction. High real interest rates will raise the cost of internal public sector debt, if at least the private sector is to be convinced to hold the extra debt voluntarily. Subsequent investment incentives to shield private investment will also imply budgetary costs.

The conclusion is twofold. First, this whole process is likely to need several iterations, until all components are internally consistent. It is almost certainly not possible to seriously design such a program without the aid of some form of quantitative analysis, if only to clearly bring out all the interdependencies and their quantitative significance. But models are by necessity imprecise, and often difficult to parameterise. Their results are important, but should for that reason be used in addition to intuitive and informed judgment; quantitative policy analysis is only one element, although an important one, in the design of good economic policy.

That qualification also leads to the second, and final conclusion. The very lack of precision of quantitative analysis, and the unpredictability of external events, calls for continuous reassessment and substantial flexibility in policymaking. Consistent and predictable policy measures are an important precondition for credibility of any program; however, policy credibility is not enhanced by clinging to views and policy measures that have been overtaken by events. There is little room for dogma in the design and implementation of economic policy.

December 1988

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The Political Management of Economic Adjustment and Reform

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One must be clear that the process of economic adjustment and reform entails social pain. The degree and distribution of that pain will vary according to the severity of the economic crisis, the specific measures that governmental authorities undertake, and the pace and sequencing measures with which they are undertaken. In what follows, an attempt will be made to suggest how the political costs of adjustment may be anticipated and how they may be kept within manageable proportions. While the words we use to describe this process—reform, structural adjustment, stabilization, streamlining, etc.—have a soothingly antiseptic quality to them, the process itself involves potential social hardship and political instability. Political leaders and social scientists, such as myself, who find themselves trying to figure out 'how to do it' are rightly disquietened about the nature of their endeavor.

Intelligent and feasible political management strategies for structural adjustment are poorly understood, and the suggestions and arguments presented below should be seen more as guides to a debate than as solid recommendations well-grounded in empirical observation and fact. Perhaps efforts of this kind will become more science than art with the passage of time and the accumulation of attempts at systematic analysis of adjustment experiences. The body of non-economic literature on these experiences is meagre. (Some of the more interesting studies in the domains of political economy and political science are listed in the bibliography.) No one can quarrel with Parvez Hasan's general caveat (Parvez Hasan, 1987: 19-20):

> It cannot be over-emphasized that a high degree of political commitment to economic development, continuity of political and economic leadership and societal consensus are essential pre-requisites for sound economic policies and economic reform programs.

The real problem, of course, is to give some operational content to this common sense warning. If those pre-requisites above were in place, at least half of the development game would already be won. There is certainly little practical knowledge that one can bring to bear on how best to evoke commitment, build consensus, and sustain stability. What is needed are insights into how to govern and administer development policy in political environments in which consensus may at best be embryonic, and instability a fact of life.

Those we may call the macro-challenges of political management, indeed of political survival. At a lower order of magnitude are two broad sets of challenges inherent in the adjustment process: social and bureaucratic. The first, on which this paper will focus, encompasses the issue of the distribution of the costs and benefits of reforms and the likely responses of affected groups in society. The second, which will receive somewhat less attention, refers to different bureaucratic interests and how they respond to the challenge of implementing (or sabotaging) reforms. In both instances, what is being sought are radically different forms of behavior on the part of groups and individuals that have become habituated to patterns that are no longer deemed appropriate, and that have developed vested interests in perpetuating the status quo. For example, public or private industrial managers may be required, abruptly, to deal with drastically lowered rates of protection after decades of selling to the sheltered markets. Or we might consider public managers who are called upon to master the challenge of quality control and market research after decades of having developed the bureaucratic skills of bargaining for resources and administrative protection from parent ministries and government overseers. Systems that have developed elaborate procedures for administered prices, foreign exchange rationing, import licensing, and non-uniform tarriff structures, have also fostered 'rent-seeking' behavior among officials who administer these

inherently discriminatory policies. Their behavior may become inappropriate, if not impossible, as more impersonal instruments of allocation and regulation are put in place. We should note at the outset that all of the seven countries that we shall be considering in greater detail below have exhibited to varying degrees these sorts of behavioral impediments to the adjustment process.

There are no guide books to help policymakers effect this kind of behavioral conversion. It is apposite to note that in the 1960s and 1970s, many developing countries, with the active support of the donor community, created a range of parastatal agencies in order to end-run older bureaucracies that were seen as too cumbersome to reform. Now those parastatals have become part of the problem rather than the solution.

Finally, at a policy level where some practical guidelines may be drawn, we encounter the specific reforms that may enter into the adjustment package. These will impact upon specific groups and will involve specific sets of administrative actors. It is not impossible to estimate the nature of the impact and to say something about how to motivate changed administrative behavior (on the latter, see Public Sector Management Unit, 1986).

In many respects the task of political management is that of coalition management. Every regime will have a set of allied interests and coalition partners that undergird its ability to govern. Consequently any regime entering into the structural adjustment process must calculate how the process will affect various members of the coalition. Coalitions vary from country to country and over time (see Robert Bates, 1981), but at any point in the reform process some coalition members stand to lose or gain more than others. The crucial challenge for political leadership is to avoid injuring the interests of all coalition members simultaneously. That may sound obvious, but often it is the case that the adjustment process is undertaken during and because of deep economic crisis when far-reaching reforms have to be initiated quickly and across the board. All that may save the regime is the fact that the level of economic distress is already very high. In August of 1983 Senegal, in the depths of drought, raised consumer prices, implemented a freeze on civil service salaries and hiring, lowered producer prices for groundnuts, and docked the public payroll to an emergency tax to relieve the drought-stricken countryside. No leader would ever voluntarily want to take on such a broad array of interests.

A fairly common pattern in LDCs is that the adjustment process entails the dissolution, or at least the realignment, of a 'populist' dominant coalition based on the military, the public sector, organized labor, and urban, white collar interests. This coalition is pro-urban, if not anti-rural, and it attempts to promote import-substituting industrialization while redistributing income from rural to urban populations and from the richer to the poorer income strata. This coalition is replaced by one that may still include the military but will rely more on commercial agriculture, private industrialists, and export sectors. Turkey, since 1980, Tunisia since the early 1970s, and Pakistan since 1977 have all undergone coalitional shifts of this nature. Distributional programs are de-emphasized, while economic efficiency and international competitiveness become the new coalition's watchwords.

Let us walk through a reform and adjustment program in two phases. The objective is to show how the sequencing of reforms may distribute burdens and rewards across potential and actual coalition members over time.

Phase I

In this phase the three policy components will be (a) devaluation, (b) deficit reduction through curtailed public investment, (c) de-indexing wages.

The objectives are to protect the devaluation by holding the domestic rate of inflation below that of the major trading partners. The reduction in public investment and the de-indexing of wages will serve this purpose. The measures should lead to promotion of agricultural and manufactured

exports. They may promote greater efficiency in public sector performance, and, as the Indian case showed after 1973 (Montek Ahluwalia, 1986), reducing investment in import-reliant public sector enterprises lowers imports significantly.

The possible beneficiaries in this hypothetical coalition, in phase one, would be agricultural exporters (i.e., cultivators already heavily involved in capitalist farming), private, and perhaps public, exporters of manufactured goods, the tourist sector, and migrant workers who can convert their earnings at the new devalued exchange rate.

The potential losers in phase one are public sector firms (reduced investment flows, restrictions on imports), any firms reliant on imported inputs, the military which may see the cost of imported armaments rise dramatically, and the construction sector which will feel the impact of curtailed public investment.

Those for whom the consequences of phase one may be neutral or indeterminate are urban populations on low and/or fixed incomes. This is so because the increase in the cost of living induced by the devaluation and the de-indexing of wages may be offset by (a) the higher value in local currency of remitted earnings from abroad, (b) the anti-inflationary impact of reduced government spending, and (c) the maintenance of consumer subsidies.

Phase II

The policy measures in this phase are: reduction in consumer subsidies, freeing-up of agricultural producer prices, lower interest rates, an increase in public investment, some deregulation of industrial prices, tarriff reduction, and constant adjustments in the exchange rate.

The goal is to maintain a moderate rate of growth and avoid stagflation, stimulate agricultural production in general and agricultural exports in particular, encourage private sector investments and a shift toward export markets, create non-agricultural jobs in order to protect incomes in the non-agricultural sector, and to absorb returning worker migrants.

The beneficiaries of this phase will be the agricultural sector in general, and exporters in particular; and public sector enterprises selling mainly to the domestic market which, after having streamlined in phase one, will not benefit from increased investment flows.

Phase II will have a neutral or indeterminate impact on public or private import-substituting industries as they will experience rising costs of domestic inputs and probably of wage bills, which may or may not be offset by easier borrowing and deregulation of prices. So also those engaged in the export of manufactured goods will experience a rise in the cost of labor and domestic raw materials.

It should be kept in mind that the spread of Islamic "no-interest" banking may reduce the effectiveness of interest rate policies in the adjustment process. Likewise, the off-budget, "no-interest" special funds in Turkey may blunt the purpose of interest rate changes.

The point of this exercise is not to suggest that these two phases (which do lead to expenditure control and switching) are the best way to proceed, but rather to illustrate how the reform agenda can be compartmentalized so as to spread the burdens of adjustment in a manner that does not harm the bulk of coalition members simultaneously. Only under the most dire circumstances should devaluation, investment reduction, de-indexing wages, and eliminating consumer subsidies be undertaken together.

The next task before us is to consider the nature of the threats that coalition members and *non-coalition members* may pose. Organized labor, for example, is generally concentrated in the most advanced and sometimes sensitive sectors of the economy. If unions go out on strike they can paralyse rail transport and ports, and close down strategic industries, as occurred in some Egyptian military factories in 1968 or in the Iranian oil fields in 1978/79. Failing to anticipate the grievances of a specific union may sometimes exact a high political price: the strike of the Guardia Civil in Peru

in February 1975 not only put an end to the country's stabilization program but eventually to the Velasco regime itself. White collar unions and professional associations were instrumental in bringing down the regime of Gaafar Nimeiri in the Sudan in March 1985. If strikes by organized labor appear likely, the leadership must try to make sure that labor grievances do not feed into those of other sectors such as students, the unemployed, and labor from the informal sector.

Unorganized labor, the urban unemployed, and the shanty-town dwellers may be the most violence-prone sectors of the population and the least protected against sudden increases in the cost of living. The results are sometimes spectacular, as was the case in Egypt in January 1977 or in Casablanca in 1965 and 1981, but the violence may not be sustained unless it attracts other elements, or links into other causes. A regime may be able to ride out the storm, if, say, organized labor has been offered some cushion against the impact of the reforms. While Bienen and Gersovitz (1985) are probably right that stabilization and adjustment programs do not usually cause violence and instability, they may ignite an already explosive situation. If, as in Peru in 1975, the police cannot be used against the rioters, or if, as in Iran in 1978 and 1979, the economic grievances of the urban population become bound up with a religious or ideological movement, the violence may become self-sustaining and draw in ever larger segments of the populace. Similarly, movements that may appear marginal or are on some extremist fringe can suddenly find willing recruits if economic hardship is abruptly imposed on a given segment of the urban population.

Austerity combined with devaluation may provoke capital flights. This is the threat or weapon of the private sector, particularly importers, financial services firms, and foreign exchange brokers. Capital flight in anticipation of a devaluation can cause more damage than the reform program may be able to correct. It is up to economists to debate the merits of a quick and significant devaluation without prior warning, or a series of mini-devaluations, or, as Egypt announced in 1986 and then retracted, a "unification of exchange rates" after 18 months. However, if importers and bankers are important constituents of the coalition, the regime may not be able to control what amounts to sabotage of an important facet of the adjustment process. Mexico was driven in 1982 to nationalize much of the private banking sector in order to stop the effects on the U.S. dollar's downward slide.

While migrant labor has nowhere been a formal or recognized component of a dominant coalition, it has shored up the foreign exchange balances of most of the countries under study. How devaluation will effect remittance flows is of vital importance. If with devaluation foreign earnings can buy more domestic currency, flows may well increase. But if further devaluations appear likely there may be an offsetting incentive to hold foreign exchange abroad in anticipation of more favorable exchange rates.

Public sector enterprises and their managers may react in a number of ways. In anticipation of devaluation they may hoard imported raw materials and capital goods, adding to the already strong run on existing foreign exchange reserves, and they may defy investment cutbacks by borrowing heavily from the public banking system or by defaulting on existing debt.

In most respects the agrarian sector stands to benefit from structural adjustment and it would only be perpetuation of the status quo of adverse terms of domestic trade for that sector that would lead to lower production and flight from 'government' crops. However, in specific instances the deregulation of prices, say on fertilizers, and the elimination of indirect subsidies on diesel fuel and electricity, would lead to sharp rises in the costs of production that would either have to be absorbed by the cultivators themselves, with unpredictable consequences, or passed on to consumers, with equally unpredictable consequences.

An Inventory of Threats

Organized labor	— strikes
Urban Lo-Inc, Unorganized	— riots
Private Sector, Importers	— capital flight
Migrant Labor and Skilled	— capital flight
Public Sector Enterprise	— hoarding and unsecured borrowing

The seven countries represented or under consideration at this seminar have coalitions of varying composition. In the table that follows, there is a very tentative identification of coalition members, and non-members, with an equally tentative estimate of their weight in the coalition.

Potential and Actual Components of Dominant Coalitions

Component	*Algeria*	*Egypt*	*Jordan*	*Morocco*	*Tunisia*	*Pakistan*	*Turkey*
Org. Labor	N	S	A	N	S-N	N	S-N
Peasantry	A	A	A	A	A	A	A
Capitalist Farmers	A	N	S	S	S	S	S
Civil Service	N	N	N	N	N	N	N
Pub. Sector Managers	S	S	W	N	N	N	N
Private Importers	A	S	?	S	?	N-S	N-S
Private Exporters	A	W	S	S	S	N	S
ISI Manufacturing	S	S	W	N	N	N	N-S
The Military	S	S	S	S	W	S	S

A = Absent; not part of the coalition. N = neutral; present but of indeterminate strength. S = strong. W = weak

No matter how approximate our estimates, there is considerable variation among the seven countries in terms of the components of the dominant coalition. In none, however, can the peasantry be said to carry much weight (although Algeria's *secteur auto-géré* is a partial exception). While the civil service is in each large and expensive, it is too sprawling and internally graduated to act corporately. And some unkind souls might argue that were it to cease to function, it may not change matters much at all.

All other categories show significant variability. The least occurs with respect to the military. In six of the seven countries, the military plays an important role in all public affairs and in policy-making. In all seven it absorbs a large part of the public expenditure and scarce foreign exchange (Egypt's military debt alone is $4.5 billion). Moreover, in Algeria, Egypt, and to a lesser extent Morocco, the armed forces control their own economic undertakings that occasionally spill over to the civilian economy. Only Tunisia has so far kept the military within manageable political and economic proportions.[1]

1. The constitutional removal of President Habib Bourguiba by General Zein al-Abdine Ben Ali in the Fall of 1987 raises the military to new prominence in Tunisia.

The place of organized labor is difficult to assess. Of the seven countries, Pakistan and Jordan do not have a tradition of powerful labor confederations. The others do possess such confederations, but they have all been subordinated to some extent to the administration and the public exterprise sector. In Egypt, for example, the giant General Confederation of Labor has been described as a "veto group" (Robert Bianchi, 1986), able to trade labor discipline against preferred policies (e.g. no joint ventures between public sector enterprises and foreign capital). In Algeria, the labor unions were brought under some control from 1967 on, although there has been a growing trend toward unauthorized strikes. The Tunisian regime has been at loggerheads with the UGTT since 1978, and while the leadership has been periodically changed, one suspects that the base is in an adversarial relationship with the regime. It is important to note that the estrangement between the government and the UGTT came about during riots stimulated by the adoption of stabilization measures in 1978, into which the leadership of the UGTT was eventually drawn. This is precisely the kind of spill-over effect that political management must seek to avoid. In Morocco, the labor movement has splintered over the years into rival confederations among which the UMT, with its aging leadership, is still predominant. As in Algeria, unauthorized strikes appear to have increased over the last decade. In Turkey, the military takeover of September 1980 led to the dissolution of the leftist DISK labor confederation, leaving the field to the main peak organization, Turk-Is, with its membership heavily concentrated in the public sector. Similarly, late President Zia-ul-Haq controlled the activities of unionized labor in Pakistan.

While the peasantry is absent from all seven coalitions, market-oriented capitalist farmers are present in six, strong in five, and absent only in Algeria. In Jordan, Morocco, Tunisia, and Turkey these groups play an important part in agricultural exports as well as producing commodities for middle- and upper-income consumers in domestic markets. They can be important supporters of adjustment programs, and because many urban elite members, including the military, have commercial agricultural interests, pro-agrarian reforms may mitigate their anti-urban impact at least for some important coalition members. In Algeria, this rural capitalist class has not yet crystalized and in Egypt, where it has yet to enter into exports, its weight in the coalition is indeterminate.

Over the long term, winning the cooperation of public sector managers to the reform program will be crucial. In all seven countries the public sector has considerable weight in terms of assets owned, people employed, sectors in which it is present, and control over foreign exchange earnings (especially from the marketing of oil, natural gas, phosphates, citrus, etc.). Egypt and Algeria, however, boast the largest and most diversified public sectors that dwarf all private sector activity outside of agriculture. Algeria still adheres to socialism but in recent years has accepted the role of private enterprise. The Algerian state is unique among the five under consideration in maintaining a monopoly of all foreign trade. Public sector managerial elites are well entrenched in the coalitions of all but Jordan, and in Egypt and Algeria they are in a position to influence if not shape macroeconomic policy. The challenge to political managers here is to restructure incentives for public sector managers to encourage new forms of behavior. Ending public sector monopolies and monopsonies, lowering tariffs, deregulating prices, and providing for real management autonomy at the level of the firm may produce the desired effect, but probably not for senior management which may prefer early retirement to the distress of learning new tricks.

Private importers, as opposed to parastatal trading companies which are present in all seven countries, play an important role in the dominant coalitions of at least three countries: Egypt, Morocco, and Pakistan. In Egypt the press frequently talks about the "Mafia of the Importers," and since the mid-1970s and with the implementation of the own-exchange system, they have handled billions of dollars worth of business each year. They are accused of willfully stifling local industry through imports (e.g. cement, textiles), of trafficking illegally in foreign exchange and drugs, and of bringing down ministers who try to regulate their activities (e.g. Dr. Mustapha Said). The major threat they pose is that of organizing capital flight in anticipation of devaluation. Depending on what

they import, they may be able to pass on the cost of devaluation to domestic consumers, but if they borrow foreign exchange to finance imports, devaluation may cripple their ability to honor their debts.

In Morocco, Jordan, Tunisia, and Turkey commercial farmers and light manufacturers have in the past 15 years moved significantly into export markets. Jordan has become an important supplier to its oil-exporting hinterland, while Morocco and Tunisia struggle desperately for market niches in the EEC. Pakistan has the potential for becoming a major grain exporter. These coalition partners will stand to benefit from the adjustment process, but policy measures that favor them may be nullified if the economic slowdown in the Gulf continues and if the entry of Spain, Portugal, and Greece into the Common Market precludes the expansion of North African exports.

With the exception of Jordan, all the countries under consideration have important public and private enterprises that grew up in an era of import-substituting industrialization. In Egypt and Algeria most of these are concentrated in the public sector, and their managers have the bureaucratic bargaining skills to hold off or deflect reforms aimed at increasing their competitiveness and efficiency. Whether public or private, trade liberalization, and devaluation will tend to hurt them by lowering e.r.p.s.[2] and raising the cost of imports. They may respond by uncontrolled borrowing from the banking system (this was the case in Chile in the late 1970s so that a neo-conservative regime found itself obliged to take over private sector banks crippled by bad debts), divestment, or running down their assets.

All of the coalition members mentioned are defined by function or the nature of their economic activity. In many countries, however, we should also pay attention to coalition members that may be defined by ethnic origin, religious status, or regional background. One thinks, for instance, of the role in the dominant coalition of Kenya played by the Kikuyu. Among the five countries here, such factors are of only marginal importance. The cleavage between Palestinians and 'Bedouin' in Jordan may have implications for the implementation of reforms (by way of simplistic example, non-Palestinian Jordanians dominate the officer corps, while Palestinians are more active in trade, industry, and white collar professions). In Algeria some have argued that there is a "Berber question" (Hugh Roberts, 1983), but given the presence of Algerians of Berber origin in all the components of the coalition, it would appear that this question is not relevant to the agenda of adjustment. Turkey and Pakistan, by contrast, face the problem of the partial 'exclusion' of major ethnoregional groups from their dominant coalitions. Two components of the adjustment package warrant separate treatment. All seven countries are in important ways dependent upon the remittances of their workers abroad for a substantial part of their foreign exchange earnings. This is least the case for Algeria, which has relied on rents from gas and petroleum exports, and most the case for Jordan where remittances have sometimes been the equivalent of two-thirds of GDP. There is, for well known reasons, likely to be a stagnation in remittances in the coming years, but it is possible that through devaluation and higher interest rates, a greater proportion of total remittances may be drawn into the formal banking system in the labor-exporting countries. A strong economic and political case for devaluation can be made on these grounds alone. That Algeria in recent years has attracted as little as $140 million in remittances is indeed strange.

The second, and related, policy issue is that of trade liberalization. It is often recommended that this be undertaken at the beginning of a structural adjustment program, but in the cases of Egypt, Tunisia, Morocco, Pakistan, and Jordan, caution is required. These five have maintained chronic trade imbalances for many years. Sweeping trade liberalizations would aggravate those imbalances before domestic actors could respond in any meaningful way. Even India, which has experimented with trade liberalization in a fairly favorable trade and balance of payments context, has run into

2. Effective Rate of Protection.

major difficulties in the past year. Algeria, which in the long run might benefit most from trade liberalization, is the least prepared to deal with the challenge in the short run.

I want to turn to some issues of political timing, policy packaging, rhetoric and style, and credibility. Joan Nelson (1984) and others have stated that the adjustment process requires a high degree of elite cohesion and the ability of the elite to project a determination to stay with the process. Some regimes enjoy that kind of credibility more than others, but when hardship is being imposed, elites that are seen by their own people as being corrupt or living beyond their means, may not have the will or the confidence to stare down the challengers to the reforms. We should also not forget that elites and coalitions may be torn asunder by the very adoption of a structural adjustment program: Indira Gandhi's devaluation of the rupee in 1966 placed strains on her ruling coalition.

It may be that democracy can be of very practical benefit to regimes undertaking painful economic measures. Most often we seem to think that democratic systems may be less capable than authoritarian ones to implement these measures. In the Middle East, Turkey has succeeded in taking tough austerity measures despite coalition governments or governments enjoying very narrow majorities. Let me suggest two electoral scenarios. In the first, leaders go to the people for a general endorsement and then, with a fresh mandate, push through the adjustment package. Abdou Diouf was elected President of Senegal in March 1983, and pushed through his austerity package the following August. Turgut Ozal has followed somewhat the same path since the first victory of his Motherland Party in 1983. The strategy can backfire; the 1977 riots in Egypt came after the parliamentary elections of November 1976, and the Plan Cruzado was in trouble in Brazil despite Sarney's becoming president (after President-elect Tancredo Neves' death). It could be that a given regime may want to make the adjustment program an open issue in the election so that an electoral victory can be claimed as a popular mandate to move ahead. It does not appear that the recent Egyptian elections were utilized for this purpose.

A second scenario would be to start implementation of the adjustment process and then call elections. The gamble here is that the countryside will have drawn benefits from the reforms and that the block of voters, more numerous than any other constituency in the country, can be mobilized in favor of the regime. In the spring of 1987 in Gambia, the President increased consumer prices, laid off 2,000 civil servants, and imposed a hiring freeze. At the same time he raised groundnut producer-prices and campaigned heavily for a re-election 'up-country'. The countryside carried him to victory while Banjul voted overwhelmingly against him. Authoritarian regimes cannot so visibly legitimize urban constituencies that will have to bear a good deal of the burden of adjustment and who are in a position to sabotage the whole process.

We have already suggested that a cardinal political error is to be driven by crisis to such sweeping and immediate adjustment measures that all coalition members are adversely affected. Even gentler approaches may fail because they become amalgamated with other grievances that may not be related to the adjustment process itself. For example, in August of 1983 the government of Morocco raised consumer prices for a number of basic goods on average by 20 percent. The increases were partially offset by salary increase of those on public payroll. At the beginning of 1984, new price increases were announced. In contrast to the relative calm of the previous summer, demonstrations broke out all over the country, especially in the northern Rif. Part of the explanation surely lies in the imposition of new burdens on an already beleaguered population. But timing was as important. Secondary school students were already agitating against sharp increases in the fees paid to take the *baccalaureat* exam and for entry to the universities. Steep exit taxes had been imposed on 'merchants' of the Rif who do business in the Spanish enclaves. The latter move was part of a general attempt to control contraband and drug traffic in the north, activities that are important to the economic life of the Rif. Finally, in order to provide security for the Islamic Summit that was held in Casablanca, police had been called in from most Moroccan cities leaving them vulnerable to the violence that eventually broke out (see J.F. Clement, 1986 and David

Seddon, 1984). Allowing these diverse issues to flow together reveals the kind of political myopia that most leadership should be able to avoid.

Structural adjustment cannot be carried out with mirrors, but I am going to make a case, one that is personally troubling, for subterfuge. The donor community seeks from developing countries clear and unambiguous statements of objectives, the explicit elaboration of the measures designed to achieve them, a binding time table, and a public commitment to the package. Leaders and policymakers should resist such displays. Progress toward reform (unless there is an authoritarian government) should be uneven, sometimes internally inconsistent, and if possible, camouflaged. The watch-word should be two steps forward, one step back, and perhaps a few sideways. Losses and benefits to various constituents should not be made clear. The higher the potential political and economic costs of structural adjustment, the greater the premium on obfuscation. Reflecting on the relative success of nine different Latin American regimes in promoting redistributive policies (not by any means equivalent to structural adjustment, but similar in their political challenges), Robert Ascher (1984:18) wrote:

> The message of this historical survey, then, is disconcertingly unheroic: the virtues of forthrightedness, openness, ideological consistency, and the courage to face attack, often turn out to be liabilities to successful redistribution. Progressive redistribution may be more readily effected when regime leaders indulge in improvisation, obfuscation, and even insincere threatening.

Political leaders generally do not need advice in this domain, but I shall nontheless put down somewhat randomly, examples of what I have in mind. How can a regime contain the appetites of its own military establishment? The Mexicans, from Cardenas on, showed how. One 'trick' was to publish in the annual budget a substantial outlay for the military and then to underspend year after year by as much as 30 percent. Another kind of subterfuge has been practiced in Egypt. Subsidies have been maintained on a whole range of items from a certain quality of bread to bus fares, while the items themselves have gradually disappeared from the market to be replaced by slightly modified but costlier items. This is de-subsidization by stealth. It does not take food from the mouths of the poor but it does avoid the kind of anger that might be expressed were prices to be raised officially.

The following is a story drawn from a real set of events but fictionalized here for obvious reasons. The leader of a large, industrializing developing country decided to reduce subsidies on a number of commodities consumed mainly in the urban areas. Some price increases would impact mainly on middle-income partners by carefully maintaining subsidized electricity rates, fertilizers, and diesel fuel for the market farmers. A few days after the price increase had been announced, delegations from his own party poured into the capital to tell him of the hardship that was being wrought on their constitutuents. Having ostentatiously received their grievances, and having demonstrated that his party had its collective finger on the popular pulse, he cut the price increase back by half. He had thereby demonstrated his concern for the masses and pre-empted any attacks from the opposition. The best part of it is that he had raised prices by twice as much as what his advisors thought was economically necessary, and he then reduced the increases to the economically optimal level. Agile-footed politicians cannot transform an economy facing structural crisis, but probably they alone can survive the reform process.

The final point to be made in this review takes us to another level of analysis altogether. We should conceive of all states as being in a constant state of adjustment to domestic and international economic forces. The state mediates the interaction of the international and the domestic. States have a limited menu of adjustment strategies to follow (see John Ikenberry, 1986):

1. They may aggressively seek adjustment in the international arena, through debt relief, preferential trade accords, concessional aid, or the New International Economic Order (NIEO) agenda.

2. They may defensively seek to protect existing advantages in the international arena, i.e., OPEC's members' efforts to maintain petroleum prices.
3. They may aggressively seek adjustment through domestic policies, such as structural adjustment programs.
4. They may undertake cosmetic, defensive domestic reforms; a form of adjustment without its substance.

Given that countries may combine at least two of these strategies, Brazil has chosen No. 1 by threatening to repudiate its foreign debt and No. 3 through the heterodox shock of the Plan Cruzado. Egypt over the last decade has chosen No. 1 by seeking debt rescheduling and No. 4. Algeria, since the collapse of petroleum prices has chosen No. 2 and No. 3 (sharp contraction of imports, public outlays, and consumer subsidies). The point is that dialogue between donors and adjusters generally focuses only on the domestic economy and the measures that need to be taken there. But this is a blinkered view, blind to the political management challenges that leaders face in balancing the adjustment demands in two interlinked arenas. After all, economists tell us that these are small, open economies, and for that reason the tasks of political management cannot be seen as stopping at the water's edge.

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Foreign Trade and Industrial Policy
Historical Perspective and Basic Policy Options

Kemal Dervis

Introduction

An extremely important part of the adjustment challenge is the supply response that is required in the productive sectors of the economy. This paper focuses on policies affecting the industrial sector, which plays a key role in the longer-run development process and which is invariably a source of hope in the design of medium-term adjustment programs. The macroeconomic scenarios worked out as part of these adjustment programs invariably stress the importance of a rapid growth of manufactured exports to improve the balance of payments and strengthen creditworthiness and ability to penetrate foreign markets, and the increase in output required to satisfy both foreign demand as well as a recovering domestic market. This paper's focus on industry should not be taken to imply a neglect of agriculture. In most countries, supply and incentive related issues are as important in agriculture as in industry and agricultural policies should be included in the design of any "adjustment with growth" strategy. Our attention in this paper, however, is concentrated on industrial policy, and trade policy as it affects the industrial sector of developing countries in general, and the middle-income countries of the EMENA region in particular.

Industrial and trade policy comprises the set of actions taken by governments or government agencies that affect the allocation of new resources as well as the use of existing resources in industry and influence the direction and composition of foreign trade. There is still much debate on what form these actions should take, indeed on whether any deliberate action is in fact desirable. To what extent should governments protect parts or all of domestic industry against foreign competition by tariffs or other protective devices? To what extent should governments be involved in export promotion? Should governments try to select certain sectors or sub-sectors and attempt to promote growth of these particular sectors? Should governments actively encourage investment in new activities and new technologies? Should governments be concerned about the number of firms and the degree of internal competition in a particular sector? Should governments regard occasional bankruptcies of important industrial firms as the normal consequence of the workings of market forces, or should governments attempt to intervene in the process of re-adjustment and restructuring? These are the important questions being discussed by economists and policymakers in the debate on appropriate industrial policies.

Before discussing some of the issues that arise in this debate, it may be worth stressing two points that have a bearing on the various arguments and that provide some background to the more detailed discussion:

First, industrial and trade policies refer to government activity. But it should be emphasized that the evolution and development of industry and trade in many countries is also the result of the research and planning activity of large corporations. The giant industrial corporations have a research, long-term planning, and resource mobilization capability that exceeds that of most governments. In the world marketplace the "output" produced by IBM, General Motors, or Hitachi is comparable to the "total industrial output" of countries such as Tunisia, Egypt, or Turkey. Just to give a sense of the orders of magnitude involved, Table 1 compares the industrial output of the EMENA countries to the output of some corporations:

It is probably fair to argue that the evolution and development of world industry is as much the result of the planned research and investment decisions of IBM, GM, or Hitachi as it is the result of policy decisions taken by the governments of countries such as Turkey or Jordan. Size is not always or necessarily an advantage in the world marketplace, but in so far as size provides some

advantage it would seem natural that, for example, the American government takes a different view of industrial policy than, say, the government of Tunisia. It can be argued in this context that the American corporations are large and powerful enough to internalize many of the mechanisms and externalities relating to flows of information and coordination of investment decisions that smaller enterprises in smaller countries cannot internalize. It can also be argued that large corporations have a degree of market power that often allows them to earn more than competitive profits. Industrial policy in smaller countries can be seen as an attempt to deal with the problem of externalities and to compensate for the market power of large organizations in the advanced economies. Note that this very argument has been used in the United States in the context of the debate on trade with the Soviet Union. It has been argued in the U.S. that American companies are at a strategic disadvantage when trading with the Soviet Union because they compete with one another while the Soviet Union behaves like a large monopolistic seller or buyer. Without necessarily agreeing with all these arguments, it is probably useful to remember that the size of countries and firms may matter when designing desirable policies. What is sensible for the government of a large country with many established industrial giants deeply involved in industrial research and industrial planning, may not be the best approach for a smaller country where family enterprises may still account for the bulk of industrial activity and where corporate institutional development is still in its infancy.

Table 1. Countries and Corporations: A Comparison of Size

Industrial Output (million U.S. $)			
Countries (1985)		Corporations (1986)	
Turkey	36,909	General Motors	102,814
Egypt	15,013	Exxon	69,888
Pakistan	20,112	IBM	51,250
Morocco	5,341	General Electric	35,211
Tunisia	2,932	Hitachi	33,210
Jordan	1,276	U.S.A.	14,938

Source: Value Line and World Bank Reports.

A second point that may be worth keeping in mind when thinking about government policy in different types of countries, relates to the process of saving, investment, and financial intermediation. Industrial progress requires the mobilization of sufficient amounts of savings in sufficient scale. In wealthy countries with a large middle class and well-developed financial institutions, private savings can be mobilized in sufficient amounts and with sufficient flexibility. But in poorer countries and in countries with less developed forms of financial intermediation, the mobilization of investment funds tends to be a critical problem. There is both a problem of quantity and a problem of flexibility. The kind of income distribution that would be required for sufficient private savings to become available may not be politically or socially acceptable. In some countries at low levels of development the social cost of large private savings may be a degree of luxury consumption that could be socially destabilizing and ultimately destructive to the entire social fabric. Moreover, even when there are sufficient quantities of savings in the economy, the lack of a developed financial system may make it very difficult to channel these savings into the most

Such differences in country size, level of development, and social structure may be relevant to the discussion of industrial and trade policy which follows below.

A Historical Perspective

In the period following the Second World War, structural change in favor of industry was viewed as a necessary prerequisite for modernization in most developing countries. The primary objective of industrial policy was to speed up the process of industrialization and to permit these countries to achieve levels of industrial development which were comparable with those in Europe and North America. Many leaders saw the huge difference in the role and importance of industry in developing countries, as compared to its role and importance in the advanced economies, as the key manifestation of backwardness and the legacy of colonial times. Mohammed Ali in Egypt provides one of the earliest examples of a strong drive towards industrialization as a reaction to backwardness and as a commitment to growth and modernization. Similar objectives guided the policies of most modern leaders in the Middle Eastern and Southern Mediterranean region. A major objective of development strategy was to increase the share of industry in total value added. Industrial policy in that context was a set of policy measures and government actions designed to shift more resources into industry, either directly through the budget, investment licensing and/or the credit allocation process, or more indirectly through the incentive system as determined mainly by tariffs, quantitative trade restrictions, and exchange rate management.

Trade policy proved to be the most convenient tool at the disposal of governments for managing the degree of external competition faced by industrial producers and promoting domestic industry. During the first phase of industrialization, the entire industrial sector was considered to be an "infant" sector in most developing economies. The infant industry argument, which had been important in the United States and other developed economies in the 19th century, was applied to the sector as a whole. High protective barriers were created behind which industry grew as an import substituting activity, oriented towards the domestic market, with agriculture and primary production and, at time, foreign capital and aid flows providing the foreign exchange needed to pay for imports.

Relatively little attention was given during the early stage of industrialization to the costs of generalized protection. Policymakers accepted the view that the initial costs of production of many activities would exceed the cost of competing imports, but the level of the cost differential was thought to be modest and its expected duration was viewed as unlikely to be excessive.

Although trade policy was almost universally adopted as a means of controlling external competition, there was considerably greater variation in the attitude of the governments toward managing competition within the protected industrial sector. The degree to which governments employed instruments to direct investment and to regulate the number of entrants into individual branches of industry was in large measure an outgrowth of the extent of their belief in the efficacy of market forces in allocating investment and ensuring cost discipline. Policymakers and economists in many of the developing countries had a profound suspicion of the ability of the market to generate and allocate investment effectively. In addition there was a widespread belief that the income distributional consequences of unregulated capitalist development would be unacceptable. While the importance of income distribution considerations varied, they tended to reinforce anti-market attitudes.

These factors gave rise to major emphasis on central planning. National plans were viewed as an essential weapon in the war on economic backwardness. Serious planning efforts started in all the countries represented here in the 1960s. In addition to the elaboration of these development plans, governments employed three major policy tools in their attempt to guide industrial development within the domestic market—direct public investment in public and parastatal

enterprises, licensing of private industrial activities, and the establishment of industrial development banks.

Public ownership of the industrial sector via both the nationalization of existing industries and new investment expanded rapidly in many countries in the 1950s and 1960s. There were basically two motivations behind the drive for public sector investment. In some countries, there was a widespread view that market incentives, even in a highly protected trading environment, would not generate sufficient entrepreneurial response to meet the perceived need for growth of a national industrial sector. In these circumstances it was argued that state should act as entrepreneur, investing across the entire range of industrial activities. In other countries there was less concern over a lack of entrepreneurship. Public enterprises were seen, more conventionally, as a mechanism for guiding investment into key industrial sectors, normally producers' intermediates and capital goods, in which private investment was viewed as insufficient or undesirable. In other sectors, public investment was viewed as a mechanism for balancing the interests of consumers with the objective of industrial development by moderating the rents which producers obtained from the structure of protection. Thus in sectors with significant scale economies, public enterprises were frequently granted monopoly positions coupled with price controls.

The attempt to control private and foreign investment rested mainly on industrial licensing mechanisms, often called industrial development acts or investment codes, which set out the terms and conditions under which non-public investments were to be undertaken. The great majority of these acts were regulatory in spirit, vesting in the bureaucracy substantial discretion over private investment. Administrators frequently used their discretionary powers to limit private investment in activities which were competitive with the public industrial enterprises, and to control the extent and terms of direct foreign investment. The extent to which industrial licensing was used to regulate competition depended in large measure on the attitude of individual governments toward the ability of the market to enforce cost discipline and efficiency select investments. In automobile production for example, two distinct models arose in the 1960s. In some countries licensing authorities permitted a wide variety of producers to establish assembly plants operating at low volumes. The rationale underlying this option was that competition among producers would eventually weed out the least efficient operations and reduce the number of competitors. In other countries the number of assemblers was severely restricted from the outset based on the argument that the minimum efficient scale of assembly operations necessitated highly restrictive licensing practices. It is important to note, however, that under both models producers were given extensive protection from external competition.

An important challenge during this first phase of industrialization was to encourage long-term investment. A key characteristic of modern economic activity as opposed, for example, to traditional agriculture, is the potential for generating high economic returns by *long gestation* investment projects. In many countries the lack of experience, political instability, and the nature of financial markets militated against long-term investment. With investment very dependent on imported capital goods, there was a basic need for long-term foreign exchange credit. It is to overcome this obstacle that special "industrial development banks" were set up with the mandate of providing long-term foreign exchange loans, particularly to the private sector and to medium- and small-scale industries.[1]

The industrial development banks were the primary channel through which long-term credit from bilateral and multilateral donors and financial institutions was made available to the private sector. The type of expertise required of industrial development banks in project identification and

1. BAD in Algeria, DIB in Egypt, IDB in Jordan, BNDE in Morocco, PICIC, NDFC, and IDBP in Pakistan, BDET in Tunisia, and TSKB in Turkey.

evaluation was not widely available in the developing economies which they served, and a major contribution of the early history of the development banking system, as well as a preoccupation of the international donors, was the creation of expertise in these areas.

Some Important Current Problems

There is little doubt that the combined effect of these policies, aided by the expansion of education and public infrastructure (transport, energy) resulted in considerable industrial growth throughout the 1950s, 1960s, and early 1970s. The emergence of the global debt crisis and the worldwide economic slowdown characterizing the late 1970s and early 1980s led to the realization that the form that government intervention took in the past has led to some important problems which pose a serious challenge to future development. The decade of the 1980s marks a period of far-reaching reforms in industrial and trade policies throughout the countries of the region as part of their overall adjustment effort. In this section we will discuss some of the key problems and offer some thoughts on directions for policy reform.

Export Incentives and Anti-Export Bias

The first important problem faced by the industrial sectors of our countries in the early 1980s is that throughout the postwar period the structure of incentives has tended to favor domestic market-oriented activity and has often severely discriminated against export industries.

By the early 1980s the size and degree of differentiation reached by industry made it difficult to consider the whole sector as an infant industry. The explicit and implicit resource cost of protecting and subsidizing the industrial sector as a whole had become unbearable. Traditional export revenues and foreign-capital flows were insufficient to cover the growing import needs of industry and the demands related to infrastructure and urban development. The need for generating an exportable surplus of manufactured goods emerged as a very important requirement for sustained growth without a balance-of-payments crisis. In this context it became clear that the infant industry argument had been applied to "infant" import-substituting activity but not to infant export industries. On the contrary, the latter had suffered from the anti-export bias of the incentive structure which was reinforced by chronic overvaluation of exchange rates.

Numerous studies carried out during the 1970s demonstrated the anti-export bias in the incentive systems of most developing economies by use of effective protection and domestic-resource, cost-measurement methodologies. On the basis of these studies, it was documented that many existing and/or potential industrial activities were, in fact, suffering from negative protection while others received very high levels of protection. The eagerness to encourage the easier steps of import substitution had led to disincentives affecting the development of a number of intermediate-goods and capital-goods and, most importantly, export industries. Moreover, there was increasing realization that the costs of generalized protection and domestic-market orientation were not only static, in the sense that costs of production exceeded world prices, but could also have adverse long-term effects as closed-trade regimes frequently exhibited low rates of productivity change and technological progress in industry, relative to the advanced countries and to their more outward-oriented counterparts. The infant industry argument, when applied to industry as a whole, was not borne out by the facts.

To illustrate this point in concrete terms, consider two industrial activities characterized by the following similar cost structures in the absence of taxes or tariffs.

	Activity 1 (Domestic Market Oriented)	*Activity 2 (Export Market Oriented)*
Price on World Market	100	100
Cost of Industrial Inputs	50	50
Cost of Inputs from Agriculture	20	20
Value-Added	30	30

Now suppose for the sake of illustration, that there is a 30 percent uniform tariff on all industrial goods. Activity 1 will benefit from this tariff because it can raise the price it charges on the domestic market and this will more than outweigh the increased cost of its industrial inputs. But Activity 2 will suffer, because it cannot raise the export price which is determined by supply and demand conditions in the world market.

With a 30 percent tariff, the cost structures are transformed as follows:

	Activity 1 (Domestic Market Oriented)	*Activity 2 (Export Market Oriented)*
Price after Tariff	130	100
Cost of Industrial Inputs	65	65
Cost of Inputs from Agriculture	20	20
Value-Added	45	15

The 30 percent tariff imposed on industrial goods has the effect of raising value-added in Activity 1 by 50 percent (45 instead of 30) but lowering it by 50 percent for Activity 2 (15 instead of 30). Suppose that wages alone are 15—this would mean that the 30 percent tariff wipes out profits in the export industry.

This example illustrates the perverse effect protectionist policies can have on export industries. Often these negative incentives affecting export industries have come about inadvertently, as an unplanned by-product of efforts to promote domestic industry. In many countries trade and industrial policies protected and supported domestic market oriented "infant industries" but not "infant export" industries. And yet export-oriented industrial production has all the benefits of industrial activity as well as some added advantages. Exporting allows the realization of economies of scale that the domestic market alone would not permit. Exporting teaches domestic procedures about the functioning of the world market. It encourages flexibility and helps domestic producers follow and better evaluate trends in prices and new technological developments. And yet many countries, without necessarily being fully conscious of it, discriminate against export activity through their tariffs and trade regimes.

Usually the first step in correcting against the anti-export bias illustrated in the example given above is to exempt exporters from import duties or to put in place a duty drawback scheme which allows exporters to be reimbursed for tariffs paid on imported inputs. In the example the tariff of 15

could be claimed back by the exporter so that his value-added would be 15 + 15 worth of duty drawback = 30, which is what it would be without the tariff. Note, however, that this does not fully solve the problem of anti-export bias because Activity 1 is still more profitable. When there is tariff with a duty drawback scheme for exporters, value-added in the domestic market oriented activity is 45 compared to 30 for exporting. Despite the duty drawback scheme there is still an anti-export bias making domestic market oriented production more profitable than exporting. Moreover, there are often administrative difficulties in implementing a drawback scheme. Producers who are primarily selling in the domestic market may claim to be exporting and try to appropriate drawback payments. Payments to legitimate exporters may be delayed for administrative and/or budgetary reasons. Finally foreign countries may try to argue that such compensating payments are "unfair" subsidies despite the fact that they only try to give back to the exporter what he should not have paid in the first place.

Clearly, the heavier the protection is on the import side, the more difficult it is to reduce or eliminate anti-export bias by compensating mechanisms. This has to be kept in mind when designing or reforming trade and industrial policies. Export industries deserve as much and maybe more priority than other industries. A great deal of progress has been made in this direction in EMENA countries in the last few years. The anti-export bias of incentives has been reduced dramatically in Turkey, but also very substantially in Morocco, Tunisia, Egypt, and Pakistan. Nonetheless, it still remains true that on average in most countries, except perhaps in Turkey, some degree of anti-export bias persists. It is probably desirable to keep monitoring this aspect of trade policy and to move as much as possible to a structure of incentives where exports are fully as profitable as sales on the domestic market, at least as a broad organizing principle, subject to some exceptions; in particular sub-sectors where a country may have some monopoly power (e.g. phosphates in Morocco, long-staple cotton in Egypt).

Too Much Variance and Inconsistency in Industrial Incentives

In the section above we discussed how a protective tariff can inadvertently lead to severe anti-export bias. The example of anti-export bias illustrates a more general problem: in today's economies which are all highly complex, interdependent systems, a policy which has the objective of encouraging a particular activity will almost always have side effects, often negative side effects, on other activities. Many countries, for example, try to encourage the domestic steel industry or local production of synthetic fibers by protecting these industries from foreign competition. Unfortunately, such measures hurt the domestic engineering and clothing industries. This is just one example of negative side effects. In complex and interdependent modern economies the multitude of policy interventions used in the pursuit of various objectives often leads to a very complicated set of incentives and distortions, so complicated that policymakers themselves no longer fully understand the impact of the various interventions.

The catalogue of price and non-price interventions which apply to the industrial sector often include: import and export reference prices, tariffs, tariff drawbacks, domestic sales and exise taxes, import quotas or prohibitions, price controls, tax exemptions, employment subsidies, preferential interest rates, and centrally allocated investment licenses. The net result of all these interventions most often is an incredibly complex and varied incentive structure where new measures superimpose themselves on older policies and where it is difficult to trace the logic of intervention back to a well-defined and consistent set of government objectives.

There is a critical need in many countries to take a comprehensive view of the impact of government intervention on the industrial sector. The current policy regime may still contain contradictory policy instruments and offsetting distortions which have developed both as a result of the ad hoc manner in which incentives were adopted and applied, and as a result of the multiple

objectives which were frequently associated with public industrial investment. In Turkey, for example, it is still the case that the investment incentives granted by the State Planning Organization at times encourage an activity which is at the very same time discouraged by an import levy on inputs imposed by the Treasury. In countries with large public industrial sectors, the control of public sector prices for both producer and consumer goods has often resulted in increasing dualism between the public and private sectors. In the public sector, incentives to industrial production conferred by the structure of protection are often offset by the effects of price control while in the private sector, the incentive effects of trade interventions tend to be reinforced by the access of firms to producer goods from the public enterprises at low controlled prices. In these circumstances, policymakers are confronted with the irony of public enterprises making large financial loses in sectors in which private firms earn substantial rents, while financial returns in both cases are an inadequate guide to international competitiveness and economic efficiency.

Progress in reforming the structure of incentives has been substantial as part of various adjustment programs and the process of reform has started in all EMENA countries in the 1980s. Turkey, Pakistan, Jordan, Egypt, Tunisia, and Morocco have all narrowed the range of tariffs, bringing down maximum rates from levels as high as 300 or 400 percent, to maximum levels between 40 and 60 percent, depending on the particular country. Tariff reform is also underway in Algeria. Morocco and Tunisia have also raised their minimum tariff levels on goods previously imported duty-free.

Tariffs are not, however, the only intervention that affects the structure of incentives. Quantity restrictions and licenses, as well as levies or reference prices of various sorts, are sometimes even more important in their impact on relative profitability.

Unfortunately, progress has often been much slower in putting greater order and rationality into these areas of policy. Clearly whether one wants to rationalize the number and structure of interventions in the industrial sector or largely eliminate them, there is a need to understand the net effect of current policy instruments. In many countries the net effect of the structure of incentives on domestic relative prices is still not fully understood. The better current distortions are understood, the easier it will be to implement a process of reform that would eliminate at least the worst excesses and inconsistencies that have accumulated over the past and that might accumulate again in response to the day-to-day pressures that will always exist. It would be desirable that in each country a control agency keeps measuring and monitoring the relative structure of incentives so that the outcome is not the uncoordinated result of many separate decisions made by separate Ministries, but does in fact reflect the overall trade and industrial strategy of the government.

The "Timing" of Industrial Promotion

Reduced anti-export bias and greater clarity and simplicity in government policies would appear to be key objectives that need to be pursued. Another important issue relates to the time frame of industrial promotion policies. What should happen over time to the level and structure of industrial incentives? Will tariffs and export support incentives remain constant over time, or will they be reduced or abolished? How long will incentive packages last? If changes are contemplated, should governments announce them in advance?

In thinking about the time profile of incentive policies, it is important to remember that the argument for special promotion or incentive policies is that initially profits in new activities will be low or even negative. Only gradually as learning takes place, new technology is mastered, and capacity utilization improves, will profits become possible. Or, to put the same argument differently, domestic production costs will, for a period at least, be higher than world prices. Nonetheless, if domestic costs fall rapidly enough, it is desirable to invest in these new activities.

Consider three possible cases. In Case 1, domestic costs forever remain higher than the projected world price. There is really no economic rationale for protecting or promoting such a sector. In Case 2 or 3, if the investment is undertaken, domestic costs will eventually fall below the import price fairly soon in Case 2 but only very late in Case 3. The fact that this will eventually happen is clearly not sufficient argument for undertaking the investment. The social profits made after time t=t* when domestic costs fall below world price should be greater than the initial social costs incurred while domestic costs exceed the import price. This is unlikely to be the case in the second example, but may be so in the third case: Case 3 appears to be only investment "worth promoting".

If capital and financial markets worked well and if industrial firms had the institutional maturity to undertake long-term investments despite substantial initial losses, it would be reasonable to expect private sector holidays or other forms of government support. In the advanced industrial economies, the private sector has developed this kind of maturity and strength. In many countries, however, investment with long gestation lags will only be forthcoming if either the rate of return is very high or if the initial losses can be moderated by some form of subsidy. In Case 3, the internal rate of return is 8 percent and positive profits appear only in the fifth year. This project may also have some "external benefits" through labor training effects that raise the social rate of return from 8 percent (private return to the investor) to 9 or 10 percent for the country as a whole. For many countries this would represent a good investment. And yet the private sector may not be willing to undertake this investment unless it can expect a profit rate of, say, 15 percent.

In such situations there is a good case for government promotion, for example in the form of a temporary production subsidy, or in the form of temporary protection if that is administratively easier to implement. But is is important to underline that the incentive offered not only can but should be temporary. For example, a five-year employment subsidy, coupled with a temporary import duty declining from 50 percent to 10 percent over eight years, could raise the private profitability of the third project from 8 to 15 percent and allow its realization by the private sector. There is no need for a high tariff or subsidy that lasts forever. On the contrary, if the 50 percent tariff was there in a permanent way, there would be the danger of having Type 2 or even Type 1 investments because they might then be privately quite profitable. Moreover, once such an investment has been made and employment has been created, the social and political pressures for continued massive protection become very strong.

It would seem, therefore, that incentives, including protection from imports, should be granted on a temporary basis with strict limits in time. The declining path of the incentive package should be clearly announced and the time limits should be credible. Such credibility will only be possible, of course, if the rules are strictly adhered to and extensions or exceptions are avoided. It may well happen that in a particular case it would make sense from the project's point of view to extend protection for another two years beyond the initially agreed time limit. However, the potential benefit from such an action should be carefully weighed against the cost it would generate by undermining the credibility of the government's industrial strategy. Rules that are strict and clear can go a long way in eliminating the costly lobbying and rent-seeking activities which use up valuable resources and divert them from the real objective of productive effort.

While there are these strong arguments for limiting the time span of incentives, there remains the question of what types of activities should in fact be promoted. One can think basically of two models. In the first model, policymakers would choose a limited number of sectors which appear promising at a particular stage of a country's development and concentrate their incentive policies on these sectors. We have already noted some serious constraints on such a policy. What is an incentive to one sector can easily become a disincentive to another sector. It is quite impossible to promote a large number of sectors at the same time. Nonetheless, it may be possible, against the background of moderate and generally uniform incentives throughout the economy and the

industrial sector, to select one or two "new" sectors at a given time, sectors in which policymakers think comparative advantage can be developed quickly, and/or sectors which are believed to generate substantial external effects through linkage or skill formation effects that cannot be fully captured by individual firms.

The second "model" is one where policymakers do not in fact try to identify potential winners but make incentive packages available to broad categories of new investments, encouraging "infant" firms and "infant" activities without, however, trying to select which of the infants are likely to grow up fastest or spread the greatest amount of external benefits. Under the rules of this second model, the government still tries to correct for market failures and inadequate institutional development by offering temporary support or protection, but it is the enterpreneurs and firms who will proceed with their own investments in any sector they wish, as long as profitability enhanced by predetermined incentive packages warrants the investment.

The choice between these two models of promotion is not an easy one. If Model 1 is used, the danger that the wrong sector is chosen is a very real one. Even the Japanese and Korean policymakers, who are widely admired for their industrial policy successes, have on occasion promoted the wrong sector or argued against the development of a sector that later turned out to be a major success. There are few countries where there are central organizations which have a quality and competence comparable to Japan's Ministry of International Trade and Industry (MITI). The scope for costly mistakes in the absence of an extremely competent and honest MITI-type "technocracy" should not be overlooked. On the whole, experience would seem to suggest that Model 2 is a safer and, in the end, more effective way of accelerating industrial growth. On the other hand, even Model 2 requires some judgment and decision-making skill at the central policy-making level. The incentive packages should be designed so that they bridge the gap between private and social profitability without creating unnecessary rents. They should apply to new activities only and it is obviously not always easy to define what is new. Finally, it must be stressed again that such selective promotion works best against the background of an outward-looking economy with very moderate average protection, when there is no general anti-export bias and "the rules of the game" are clear, credible, and announced in advance. Much progress remains to be achieved in this area in EMENA countries. The fierce debate that took place recently in Morocco on the 1988 Loi de Finances and, more particularly on the "Codes d'Investissements" is a good example of what is involved. The government tried to limit in time promotion measures that had essentially an open-ended character and faced fierce resistance by various interest groups. A very delicate balance has to be struck in this area and, again, the need for close monitoring and accurate measurement by a competent public authority should be emphasized. For many countries, a consolidation of the various agencies involved in trade policy and industrial promotion into a single "Ministry for Industry and International Trade" could be a desirable alternative.

Management, Organization , and Ownership Issues

Much of the discussion and debate on approaches to industrial policy focuses on the incentive structure and the environment in which the firm has to operate. A multitude of careful empirical studies all over the world has demonstrated the importance that prices, tariffs, and subsidies play not only in influencing resource allocation and allocative efficiency, but also in determining the effectiveness of resource use and productivity performance.

While the importance of price incentives and related policies is well established, it must be emphasized that incentive policies interact with the institutional and organizational characteristics of the industrial sector in a particular country. The individual enterprise and its behavior has to transmit price or incentive signals to the productive process. The enterprise is to the economy what the cell is to the living organism. Cells can only live and thrive in a healthy organism. But causity also runs

the other way. The organism can die if individual cells misperform, even though the overall anatomy and physiology may be acceptable.

One of the most important characteristics of the individual cell in an economy—the enterprise—is the quality of its management. A large number of quantitative studies of total factor productivity over time have demonstrated the critical importance of the nature and of the quality of enterprise management. Note that it is both the "nature" and the "quality" that matter. Suppose, for example, that a manager's objective is to "increase the size of his firm." If the environment is not competitive and there is not enough financial discipline, he might be very effective in pursuing this objective and ruin the economy in the process. The same kind of thing often happens in large bureaucracies. A department manager might succeed in doubling the size of this department; whether this in fact is in the interest of the organization as a whole may be very doubtful. The existence of "strong drive at the top" is not enough. This drive must be focused on efficiency, innovation, and profitability. It is only when each "cell" performs efficiently, innovates, and constantly seeks new opportunities to deliver more output at lower cost that the entire industrial sector will grow rapidly, generate productive and well-remunerated employment, and become a source of know-how and strength for the rest of the economy.

It is, therefore, of utmost importance for policymakers to reform organizational or structural features of industry that inhibit efficiency-oriented management. Unfortunately, a major problem in this context is often the intrusion of short-term political behavior on economic decisionmaking, particularly in the case of public sector enterprises. Because of the scarcity of private entrepreneurial talent, the lack of sufficient private savings, or a commitment to egalitarian income distribution, many countries have very large segments of their industries in the public sector. There is no doubt that public industrial enterprises have made valuable contributions to the development process. In Turkey, for example, industrial growth was first launched in the 1930s by the State Economic Enterprises and their initial performance was admirable in a setting where there was no private entrepreneurial class and very little scope for private industrial investment. There are many other examples of successful public industrial enterprises in particular countries at particular times. One of the most efficient steel plants in the world, for example, belongs to the publicly owned Pohang Iron and Steel Corporation in Korea. In the majority of cases, however, public industrial firms tend to face constant political interference; they are pressured into uneconomic behavior particularly in the employment area, and they often become large but weak bureaucratic organizations that do not transmit price and incentive signals to the productive sphere and that are unable to generate the investable surplus necessary for continued growth. Unfortunately, this has been the case throughout the EMENA region.

It has, therefore, become necessary to take a fresh and comprehensive look at the structure and organization of the industrial sector, evaluate the degree of competition that exists in the various subsectors, and analyze the wisdom of the existing balance between the public and private sector as well as the rules and habits that characterize managerial behavior in both sectors.

An open trading environment, emphasis on export and world market orientation, and clear rules against long-term protection, will go a long way in encouraging competitive behavior and effective management in both the private and the public sectors. But in the public sector, there are additional issues that must be resolved. Industrial enterprises must be efficient, cost-cutting, innovating "cells" of the industrial organism and not servants of a bureaucratic administration. There is often chronic and difficult-to-overcome tension between day-to-day politics and the requirements of efficiency and economic rationality. Past experience would seem to suggest that broad social or political objectives should be pursued without creating conflict with the requirement of industrial efficiency. It may be, for example, that it is socially important to make low-cost clothing available to the poorer segments of the population at prices below production cost or import cost. The subsidies that this requires can be targeted at low-income groups and given at the wholesale or retail level, but not

administrative price controls on public or private sector firms. To take another example, it may well be that, at times, fertilizers should reach the agricultural sector at a cost lower than current world prices. But again, this can be achieved, without price controls, by direct user subsidies. For productive industrial firms, private or public, to generate growth, resources, and wealth, they must be able to focus on economic rationality and they must be free to compete. They must constantly adjust and they must be allowed the rewards of successful effort. It is much better for the State to find other ways to pursue important and valuable social objectives, ways which diminish the tension between the political and the economic sphere and do not disturb the health of the individual enterprises, allowing them to perform their productive functions and succeed in a world of constant change and difficult international competition.

In all EMENA countries there are ambitious moves to reform, restructure, and sometimes privatize public enterprises. Progress, however, has been extremely slow. Privatization is turning out to be a much more complex undertaking than some imagined. It is certainly not a "quick fix" to the problems of efficiency in the public sector. It is important, therefore, to address the public sector efficiency problems directly, whether or not some form of privatization is pursued and whatever the pace of privatization. In the near future, an important share of the productive economy will remain under public ownership and cannot be neglected. The process of rationalization and restructuring of these enterprises remains a key priority for industrial policy.

Conclusion

These are some of the big issues facing policymakers in the EMENA region. Of course, conditions and levels of development differ. But all face the tremendous challenge of catching up, of growing rapidly, and of mastering fully the skills and the technology that can form the only solid basis for greater prosperity.

How much the state can or should do and how much can be left to decentralized market mechanisms is a question that perhaps is often debated in wrong terms. The answers are not as obvious as simple theories may suggest. Why is it, for example, that a company like General Electric, equal in terms of output produced to the entire industrial sector of Turkey, produces a wide range of products from simple light bulbs to jet engines, and yet finds it useful to remain as an admittedly decentralized but nonetheless integrated single organization? There seem to be important benefits in some forms of centralization and strategic planning, provided that the environment remains strongly competitive. Centralization and decentralization may have to be seen as potentially complementary principles, rather than as opposite and irreconcilable extremes. Well-designed government action can reinforce the market mechanism, while the existence of vigorous market competition is probably, in turn, the essential requirement for effective government action. The same kind of basic philosophy may be relevant not only at the level of each individual country, but also when evaluating joint ventures and closer policy collaboration between countries. For the nations of this Region, it may be possible, for example, to encourage the development of strong, regional, multi-national firms. Such firms could be champions of industrial progress and technological development on a regional scale. These firms may need initial support, encouragement from governments, and political guarantees. However, they should rapidly become able to compete without government subsidies and without special protection. The world market as a whole should be their target, not a sheltered and limited regional market.

These considerations lead to a very important aspect of the "sociology of development". Economic success must be built on social cohesion and, in particular, on a strongly supportive relationship between the government and the private sector. It is this cohesion that may well be the ultimate secret explaining the incredible success of some East Asian nations. History has shown that "statism," which relies on centralized allocation decisions and limits the initiative and creative

energy of the private sector, has not led to sustained rapid development. On the other hand, a private sector-focused strategy that underestimates the need for a highly skilled and well-organized public administration is unlikely to be sufficient. It is when private entrepreneurs and highly competent government officials work together in pursuit of rapid growth with dedication by both to the same national goals, that development really succeeds.

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